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The Status of Shareholders and Directors under New York's Business Corporation Law: A Comparative View

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THE STATUS OF SHAREHOLDERS AND DIRECTORS UNDER NEW YORK'S BUSINESS CORPORATION LAW: A COMPARATIVE VIEW

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COMPRESSING the protean subject matter of Articles 6 and 7 of the new Business Corporation Law, dealing with shareholders and directors, into some eighty or ninety law review pages strikes one at the outset as an awesome if not insuperable, assignment. The necessary and, indeed, unique solution—once the originally-induced paralysis has abated—is to jettison or, to put it perhaps more professionally, to yield materials in this symposium to the expertise of collaborating brethren. So, for example, one may, with maximum confidence, cede to Dean Stevens those sections of Articles 6 and 7 designed exclusively, or of primary importance, for the close corporation, and to Dean de Capriles the subject matter of corporate finance affecting the dividend, redemption, conversion, option and related financial rights of shareholders. Likewise, the mechanics of shareholder meetings, voting and quorum requirements, and related materials in Article 6, as well as similar areas in Article 7 dealing with the number, election, classification, vacancies, removal, and meetings of directors will be left to discussion elsewhere in this symposium. After such extensive abdication of materials (purely in self-defense), there remains for evaluation in this paper the still impressive area of basic shareholder rights and liabilities, and the duties, rights and liabilities of directors.

Although the subject matter selected for discussion, particularly in Article 7, impinges squarely on sensitive and crucial areas of policy, reflecting very directly the legislative inclination with respect to the regulatory (or policing) function of corporate statutes, this paper will not attempt a critique of the policy orientation of the legislature, nor will it assume an advocate position on the embattled (and rather wearisome) issue of the "paternalistic" versus the "permissive" system of corporate statutes. There is no gainsaying the fact that New York has adopted a more permissive system under the new law. The die has been cast, although not irretrievably, and the ultimate "wisdom of the legislature" in its policy formulations must await the test of time. The decisions that have been made are not so clearly erroneous or dangerous that one is obliged, as a matter of professional or social conscience, to cavil at them.

On the assumption that the major emphasis of this symposium is the enlightenment of the New York practising bar, the provisions of the new law in the areas selected for discussion will be contrasted with their counterparts, if any, under existing law, evaluated critically where necessary, and generally explored. Spatial considerations preclude any, but the most trifling, comparative analysis of the new law and the law throughout the country.

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The Status of Shareholders

I. *Shareholder Rights*

The shareholder's "equity" in the corporation is represented by his component rights of participation in the corporate enterprise, traditionally referred to as the "bundle of rights" constituting full share ownership. Time was when the New York courts tended to define the several component rights, such as voting, dividend, preemption, etc., as vested rights of property. More recently, however, the Court of Appeals in *Davidson v. Park, Austin & Lipscomb*[1] took another look at the "vested rights" concept as it related to the state's reserve power—and decided that it was no longer feasible, in light of the realities of the modern corporate world, to go along with the past rigid definition of component shareholder rights as vested rights of property, guaranteed against impairment or even total destruction from the exercise of the state's reserve power. Such definition, it said, was disfunctional and misleading, and "only confusion results from saying that 'vested rights' are not within the contemplation of the statute. All preferential rights of stockholders are in a sense vested. They are all property rights founded upon contract. . . . The inadequacy of the 'vested rights' test is further demonstrated by the fact that new stock may be issued with preferential rights to the assets of the corporation upon dissolution and to dividends superior to the preferential rights of the then outstanding shares . . . , even superior to the right of preferred stockholders to dividends in arrears. . . . *The judicial problem is not whether a particular preferential right is vested or not, but rather what was the legislative intent as to it.*"[2] (Emphasis added.) Yet, so strongly and ineradicably entrenched was the traditional sense of the vested property character of the component shareholder rights that, when in 1943, under the influence and authority of the *Davidson* case and in reaction to strong pressure from organized business, the legislature enacted the present paragraph 3 of Section 35 of the N.Y. Stock Corporation Law authorizing certificate of incorporation amendments to alter or eliminate voting, preemptive, redemption, and sinking fund rights, and rights to undeclared cumulative or non-cumulative dividends, whether or not accrued, it provided shareholders adversely effected with a correlative right of appraisal.[3] Other rights, such as the right of inspection and the right to maintain a derivative action, remained solidly entrenched, unimpaired by amendment and judicially protected. What has happened to the more important shareholder rights under the new law?

A. *The right to maintain a derivative suit; security for expenses*

The real office of the controversial derivative suit, that ingenious invention of equity, has perhaps never been put more astutely or accurately than in the following comment:

1. 285 N.Y. 500, 35 N.E.2d 618 (1941).
2. Id. at 509, 35 N.E.2d at 622.
3. See N.Y. Stock Corp. Law § 38(11).

> Despite the numerous abuses which have developed in connection with such suits they have accomplished much in policing the corporate system especially in protecting corporate ownership as against corporate management. They have educated corporate directors in the principles of fiduciary responsibility and undivided loyalty. They have encouraged faith in the wisdom of full disclosure to stockholders. They have discouraged membership on boards by persons not truly interested in the corporation. . . . The measure of effectiveness of the stockholder's derivitive suit cannot be taken by a computation of money recovery in the litigated cases. The minatory effect of such actions has undoubtedly prevented diversion of large amounts from stockholders to management and outsiders. Corporate attorneys now have an arsenal of authorities to support their cautioning advice to clients who may be disposed to risk evasion of the high standard the courts have imposed upon directors.[4]

It is indeed surprising that so sensitive an instrument for regulating the internal tensions of the highly complex corporate system should, particularly in New York—the financial mecca of the world, have been heretofore solely the product of judicial engineering. It has now by virtue of *Section 626* of the New York Business Corporation Law come under statutory regulation—mainly a codification of existing judicial authority.

The very definition of the derivative action has been a source of confusion in the courts. Traditionally, such suits have involved accounting actions brought to recover corporate funds allegedly wasted or converted by faithless directors or officers, or expended by the corporation as a result of their negligence or breach of fiduciary duty.[5] Title to such a fund being in the corporation alone, the right to sue for its recovery has been held uniformly to belong primarily to the corporation—the injury to the shareholders being indirect and secondary.[5a] In the recent case of *Gordon v. Elliman*,[6] the Court of Appeals by a closely divided court fixed a broader and very different standard for defining the derivative action. The case involved an action brought by a shareholder to compel the corporation and its directors to declare a dividend. The corporation sought security for expenses under Section 61-b of the N.Y. General Corporation Law (which in terms applies only to derivative suits) and the character of the action was put in issue. The majority held the action to be derivative on the ground that in declaring or refusing to declare a dividend the board performs a duty which it owes primarily to the corporation and secondarily to the shareholders. The majority suggested that "the idea is too restricted that derivative actions are limited to such as are brought to compel the directors to pay or restore money to the corporation. . . . *In general, it may*

4. Brendle v. Smith, 46 F. Supp. 522, 525-6 (S.D.N.Y. 1942).
5. Judge Desmond's individual dissent in this case is based squarely on this view of the derivative action.
5a. See, for example, Niles v. N.Y.C. & H.R.R.R. Co., 176 N.Y. 119, 68 N.E. 142 (1903).
6. 306 N.Y. 456, 119 N.E.2d 331 (1954).

be said that an action is in the right of the corporation which invokes the equitable powers of the Supreme Court to direct the management of its affairs . . . the object is for the court to chart the course for the corporation which the directors should have selected . . . the court substitutes its judgment *ad hoc* for that of the directors in the conduct of its business. That applies to the establishment of a suitable dividend policy for the corporation as much as anything else. A stockholder has no individual cause of action to recover dividends that have not been declared. All that he can do is sue in equity to cause the court to perform a corporate function which the directors would have done except for their bad faith."[7] (Emphasis added.) A distinction was drawn between an action to recover a dividend already declared or a "guaranteed" dividend and one to compel the declaration of a dividend. In the latter case, it is "an over-simplification to treat such an action . . . as being by individual stockholders against the corporation to enforce a contract right"[8] and the notion that the corporation is simply an adversary interested only in defeating the shareholder's claim is erroneous. "A corporation has an interest of its own in being well managed."[9] In a sharp dissent in which he spoke for a 3-judge minority, Judge Fuld alluded to the test selected by the majority as turning on whether the shareholder was suing to enforce a chose in action belonging to him or to compel the directors to perform a duty which they owe to the corporation and, through it, to the shareholders, and suggested that "the vice of the test is that it presupposes that every duty owed by corporate directors runs exclusively to the corporation as such and never directly to the stockholders in their personal and individual right. The law is otherwise."[10] All suits brought against the corporation, as was this one, necessarily involve the conduct of directors (or responsible officers) and an attack upon such conduct is not automatically converted into the assertion of a corporate cause of action. The shareholder's interest in the corporation is fundamentally contractual, comprehending a number of component rights, and actions brought in the vindication of such rights have been traditionally treated as brought primarily in the right of the shareholder. So, in *Witherbee v. Bowles*[11] a suit brought to enforce a preemptive right was held personal to the shareholder, and in *Horowitz v. Balaban*,[12] a federal court held such an action outside the ambit of Section 61-b. Similarly, an action to compel an inspection of the corporate books, to vote, to compel registration on the corporate books, or to restrain a wrongful issuance of shares would be personal to the shareholders bringing such actions. Said Judge Fuld, "I can conceive of no more important or generally understood right of the stockholder in a modern corporation, where he is primarily an

7. Id. at 461-462, 119 N.E.2d at 335.
8. Id. at 465, 119 N.E.2d at 337.
9. Id. at 466, 119 N.E.2d at 338.
10. Id. at 470, 119 N.E.2d at 340.
11. 201 N.Y. 427, 95 N.E. 27 (1911).
12. 112 F. Supp. 99 (S.D.N.Y. 1949).

investor, than of receiving dividends on his investment."[13] The fact that in the case of common stock this contractual right to dividend is not spelled out in the certificate of incorporation, as is generally true for preferred stock, does not make it any less a right of the shareholder and a correlative duty of the corporation. "And the corporation's *duty* does not become its *right* merely through the omission of express language in the certificate, for the law reads in the words as clearly as if they were spelled out. The right is the stockholders', whether the promise to pay the dividends is expressed or implied."[14] Finally, in an action to compel a dividend declaration, the corporation may be sued as sole defendant—"nothing can be more patent than that the lone defendant in an action is not the owner of the right upon which the suit is grounded. The circumstance that no other defendant than the corporation is necessary is explainable only by recognizing that the corporation is in reality the true adversary."[15]

The lower courts have not displayed any marked tendency to apply the broad standard of *Gordon v. Elliman* in cognate cases. For example, in *Lehrman v. Godchaux Sugar*,[16] security for expenses under Section 61-b was sought in an action brought by a Class A shareholder to enjoin a proposed recapitalization. Under the proposed plan, the Class A shares would preserve their previous dividend preferences but would lose their previous right to participate in any additional dividends with Class B shares. In exchange for the loss of participating rights, Class A was made convertible at its option into Class B shares within a prescribed period of time. Changes were made as well in the liquidation amounts receivable by the Class A and Class B shares, generally detrimental to Class A. The court held that the action was not derivative and alluded to the circumstance that Judge Fuld in his dissenting opinion in *Gordon v. Elliman* had used a similar contest between two classes of shares to illustrate a situation which would concern the shareholders involved rather than the corporation. The court commented that "In a sense, of course, the corporation and its stockholders usually have the same interests. This normal community of interest must not, however, obscure the line of demarcation between the juridical basis of their respective rights."[17] In similar vein, it has been held that an action to procure the dissolution of a corporation is not derivative.[18] Nor have the federal courts been persuaded by the majority view in *Gordon v. Elliman*—both the third[19] and fifth circuit[20] courts of appeals having recently expressly repudiated it and held squarely that an action to compel the

13. Supra note 6 at 471, 119 N.E.2d at 341.
14. Id. at 472, 119 N.E.2d at 341.
15. Id. at 475, 119 N.E.2d at 343.
16. 207 Misc. 314, 138 N.Y.S.2d 163 (Sup. Ct. 1955).
17. Id. at 318, 138 N.Y.S.2d at 167.
18. Fontheim v. Walker, 141 N.Y.S.2d 62 (Sup. Ct. 1955); Davidson v. Rabinowitz, 140 N.Y.S.2d 875 (Sup. Ct. 1951).
19. Knapp v. Bankers Securities Corp., 230 F.2d 717 (3d Cir. 1956).
20. Doherty v. Mutual Warehouse Co., 245 F.2d 609 (5th Cir. 1957).

declaration of a dividend is brought in the primary right of the shareholder. Law review commentators have been equally unimpressed.[21]

Gordon v. Elliman is reactionary in effect. To impose upon the minority shareholder, seeking judicial review of the corporation's failure to declare a dividend, the burden of securing the corporation's expenses in the action is to throttle the cause of action in its infancy. *Paragraph (a)* of Section 626 authorizes the maintenance of an action in the right of a domestic or foreign corporation to procure a judgment *in its favor*. The reviser's note to Section 626 indicates that the addition of the language "in its favor" is designed to overrule *Gordon v. Elliman*. In the writer's opinion it does not, standing alone, accomplish this laudatory purpose—it is "question-begging" language. Whether an action is brought in favor of the corporation or the shareholder is precisely the question to be decided in each case. Perhaps, however, the evidence of legislative intent reflected by the reviser's note to Section 626 will induce the Court of Appeals to reconsider *Gordon v. Elliman* upon some future occasion—a consummation devoutly to be desired.

Paragraph (a) provides expressly that derivative actions may be brought by a holder of voting trust certificates or of a beneficial interest in the shares. This is representative of existing case law.[22] Practical difficulties may arise with respect to the authority conferred upon beneficial owners to initiate such suits in view of the "contemporaneous ownership" provision in *paragraph (b)*, the counterpart of present Section 61 of the General Corporation Law, that "in any such action, it must be made to appear that the plaintiff is such a holder at the time of bringing the action and that he was such a holder at the time of the transaction of which he complains, or that his interest devolved upon him by operation of law." Where the shares are held by a broker, as nominee, the shareholder may believe himself in possession of continuous beneficial ownership of shares in the corporation but the broker's record ownership (representing a large number of beneficial owners) may fluctuate considerably, or he may even have withdrawn record ownership altogether on a temporary basis, pursuant to contractual arrangements with the customer—a customary practice. Should the transaction complained of occur during a period when the broker's record holding in the corporation is lowered (below the amount of plaintiff shareholder's beneficial ownership) or has been temporarily withdrawn, can it be said that the shareholder so represented held a beneficial interest in the shares at the time of the transaction of which he complains? Nor is it clear, under the formulation in paragraph (b), that

21. These comments were uniformly in opposition. See 19 Brooklyn L. Rev. 312 (1953); 38 Cornell L.Q. 244 (1953); 30 N.Y.U.L. Rev. 534-5 (1955); 19 Albany L. Rev. 84 (1955); Note, 30 Ind. L.J. 118 (1955).

22. See White v. National Bondholder's Corp., 117 N.Y.S.2d 450 (Sup. Ct. 1947); Lewin v. New York Ambassador, 61 N.Y.S.2d 492 (Sup. Ct. 1946), aff'd, 271 App. Div. 927, 67 N.Y.S.2d 706 (1st Dep't 1947); Braman v. Westaway, 60 N.Y.S.2d 190 (Sup. Ct. 1945). See also Mattheis v. Seymour Mfg. Co., 270 F.2d 365 (2d Cir. 1959), cert. denied, 361 U.S. 962 (1960).

the shareholder must not have *continuous* (record) ownership from the time of the transaction until the time he brings the action.

The clause in paragarph (b) authorizing the initiation of a derivative suit by a holder whose "shares or his interest devolved upon him by operation of law" perpetuates a parallel clause in the present Section 61 of the General Corporation Law that has received considerable construction. There is uniform agreement in the decisions that "equitable" ownership suffices to enable such holder to sue derivatively—legal or record ownership not being indispensable. Thus, in *Braman v. Westaway*,[23] the beneficiary of a testamentary trust was held to have a sufficient equitable interest in the trust shares to sue derivatively. However, a derivative suit may not be maintained by a plaintiff who is neither the legal nor equitable owner of shares but is merely interested as beneficiary in an estate of which the shares are an asset. In *Steuer v. Hector's Tavern*,[24] the Appellate Division, First Department, recently held that plaintiff-widow of a deceased shareholder, who had consented to accept shares in the corporation (as yet undistributed) in part payment of her elective share in the estate, could not bring a derivative suit because she had acquired only an interest in the estate of which the shares were an asset, not an interest in the shares themselves. The same rule was recently followed by the Appellate Division, Second Department, in *Faiello v. Li Castri*[25] where a statutory distributee of a one-ninth interest in an intestate estate was held disabled from commencing a derivative action. Of course, the specific legatee of shares acquires his interest by operation of law,[26] as does an executor of an estate of which the shares are an asset.[27] It has been held, however, that the interest of trustee-remaindermen of an *inter-vivos* trust does not devolve by operation of law but vests pursuant to the grant.[28] A number of questions related to the "contemporaneous ownership" rule remain unresolved under the new law. The Model Act formulation, followed in several states, that where an interest in shares devolves upon plaintiff by operation of law, his predecessor in interest must have been a holder at the time of the transaction complained of, has not been adopted. The omission to do so is rather perplexing since, although no square New York case in point has been found, the Model Act formulation would seem dictated by a consistent application of the contemporaneous ownership rule.[29] In addition, the recent Appellate Division, Second Department holding

23. Supra note 22.
24. 1 A.D.2d 1003, 151 N.Y.S.2d 830 (1st Dep't 1956).
25. 2 A.D.2d 749, 153 N.Y.S.2d 247 (2d Dep't 1956).
26. See Singer v. State Laundry, 188 Misc. 583, 68 N.Y.S.2d 808 (Sup. Ct. 1947).
27. See Salter v. Columbia Concerts, Inc., 191 Misc. 479, 77 N.Y.S.2d 703 (Sup. Ct. 1948).
28. Myer v. Myer, 271 App. Div. 465, 66 N.Y.S.2d 83 (1st Dep't 1946), aff'd, 296 N.Y. 979, 73 N.E.2d 562 (1947).
29. It was suggested in Continental Securities Co. v. Belmont, 206 N.Y. 7, 13, 99 N.E. 138, 140 (1912) that the shares are tainted in the hands of plaintiff-shareholder if his predecessor in interest had acquiesced in the wrong. For the rule that the complicity of plaintiff-shareholder in the wrong precludes his bringing the suit, see Diamond v. Diamond, 307

in *Richman v. Felmus*[30] has muddied what had seemed to be a clear rule to the contrary in New York[30a] by holding that intervenors in a derivative suit, as well as its originator, had to be contemporaneous owners. Although intervention by non-contemporaneous owners was disallowed by the court for the purpose of escaping the need to secure the corporation's expenses in the suit, it appears to have been permitted with respect to the second cause of action for which there was ostensibly sufficient contemporaneous ownership to satisfy the security for expenses requirement. This area might have been clarified.

In addition to contemporaneous ownership, paragraph (b) imposes the requirement that the plaintiff must likewise be a holder of shares at the time of bringing the derivative suit. The New York decisions impose the added requirement that the plaintiff preserve his shareholder status for the duration of the proceedings until final judgment, or his right to continue prosecuting the action is lost. In the recent case of *Tenney v. Rosenthal*,[31] the Court of Appeals recognized the foregoing rule but distinguished the case of the director who is deposed pending the final determination of a suit he has brought on behalf of the corporation against other derelict directors. In such case, the deposed director may proceed with his suit because "His right to sue is based on the public policy declared by the legislature upon enactment of the statute.[32] We may assume that the right to bring suit has been granted in order to facilitate and improve the director's performance of the 'stewardship obligation' which he owes to the corporation and its stockholders and to protect him from possible liability for failure to proceed against those responsible for improper management of the corporate affairs."[33] The Court stated by way of contrast that the shareholder in bringing a derivative suit is a volunteer who sues to defend his own interests as well as those of the corporation and that "By the voluntary abandonment of his personal interest in the ligation, he has also by implication abandoned the cause of the corporation. However, no such abandonment of the corporate cause is inferable when the plaintiff director has failed of re-election as a director."[34]

Paragraph (*c*) adopts that portion of Rule 23 (b) of the Federal Rules of Civil Procedure which provides that the complaint set forth with particularity the efforts made by the plaintiff to secure the initiation of such action by the board of directors or the reasons for not making such effort. This restates the

N.Y. 263, 120 N.E.2d 819 (1954). See also Capitol Wine & Spirit Corp. v. Pokrass, 277 App. Div. 184, 98 N.Y.S.2d 291 (1st Dep't 1950), aff'd, 302 N.Y. 734, 98 N.E.2d 704 (1951); Gottfried v. Gottfried, 112 N.Y.S.2d 431 (Sup. Ct. 1952).

30. 8 A.D.2d 985, 190 N.Y.S.2d 920 (2d Dep't 1959).

30a. See, authorities cited infra note 53.

31. 6 N.Y.2d 204, 160 N.E.2d 463 (1959). See, also, Gleicher v. Times-Columbia Distributors, Inc., 283 App. Div. 709, 128 N.Y.S.2d 55 (1st Dep't 1954).

32. This alludes to N.Y. Gen. Corp. Law § 61 (see N.Y. Bus. Corp. Law § 720(b)).

33. Supra note 31 at 211, 160 N.E.2d at 467.

34. Id. at 212, 160 N.E.2d at 467.

New York common law rule.[35] What is significant, however, is the absence from paragraph (c) of that portion of Rule 23 (b) requiring a statement in the complaint of similar efforts to secure action "if necessary, from the shareholders." It is noteworthy that this "demand upon the shareholders" requirement appeared in the study bill prepared for the 1960 legislative session but was removed from the bill presented for passage at the 1961 legislative session after argument was advanced at a public hearing that the added requirement of a demand upon shareholders was too onerous, particularly in the case of suits brought against directors and officers of large corporations with farflung stockholdings. It should be observed that in both the federal Rule 23 (b) and the (1960) study bill, the demand upon shareholders is required only "if necessary." This rather ambiguous qualification presumably means "if necessary" *under the (common) law of the state.* In New York, the leading case on the subject is the often-cited *Continental Securities Co. v. Belmont*[36] in which the Court of Appeals rejected the demand on the body of shareholders as a *general* requirement for the initiation of a derivative action on the ground that the corporate body (to which the action belongs) is represented by the directors and that the "demand on shareholders" argument misconceives the essential role of the shareholders as a collective group. Their role, said the Court, is not to initiate corporate action but rather to recommend action or, in some cases, to assent to certain corporate undertakings under authority conferred by statute. The Court noted that certain actions of the board of directors which are legal, but voidable, can be ratified and made binding on the corporation by vote of a majority of the body of the shareholders as the ultimate parties in interest. Such right to ratify is confined, however, to acts voidable by reason of irregularities in the make-up of the board or by reason of transactions between an interested director and his corporation but does not extend to board actions prohibited by law or against public policy, and surely not to frauds and the misappropriation of corporate funds. The Court concluded that "[A] complaining stockholder must go to such board for relief before he can bring an action, unless it clearly appears by the complaint that such application is useless. *If the subject-matter of the stockholder's complaint is for any reason within the immediate control, direction or power of confirmation of the body of stockholders, it should be brought to the attention of such shareholders for action, before an action is commenced by a stockholder unless it clearly appears by the complaint that such application is useless.* . . . If the body of stockholders has no adequate power or authority to remedy the wrong asserted by the individual stockholders it is unreasonable and unnecessary to require an application to it to redress the wrong before bringing a representative action."[37] (Emphasis

35. See Continental Securities Co. v. Belmont, 206 N.Y. 7, 99 N.E. 138 (1912).
36. Ibid.
37. Id. at 19, 99 N.E. at 142.

added.) It is patent that under the foregoing "ratification" theory of the *Belmont* case the "demand upon the body of shareholders" requirement will ordinarily be of little consequence in derivative suits which generally are premised on allegations of fraud or other non-ratifiable wrongdoing. In a recent case, *Gottesman v. General Motors Corporation*,[38] Chief Judge Clark speaking for the majority of the United States Court of Appeals for the second circuit, after rejecting the demand upon shareholders as unrealistic for the large corporation and based on a fundamental misconception of the role of the body of shareholders in corporate management, downgraded the approach of *Continental Securities v. Belmont* with the remarkably cynical comment that "at best a ratification by the body of shareholders merely compels the minority shareholder plaintiffs to shift slightly the legal theories on which they rely so as to raise charges of fraud, waste of corporate assets, or the like."[39] The reviser's note to Section 626 states laconically that the demand upon the shareholders has been omitted from the section. The requirement for such a demand when necessary having been included in the (1960) study bill version of the derivative action section, the interesting (and perplexing) question is the effect its omission from the present (1961) section will have on the future of *Continental Securities v. Belmont* in New York.

Paragraph (d) overrules *Manufacturers Mutual Fire Insurance Co. of Rhode Island v. Hopson*[40] and an old dictum in *Brinckerhoff v. Bostwick*[41] to the effect that the plaintiff in a derivative action may discontinue such action at will at any time prior to the intervention of another shareholder or the entry of a final judgment in the action. The change, fashioned after Rule 23(c) of the Federal Rules of Civil Procedure, is long overdue. The statute now provides that "such action shall not be discontinued, compromised or settled without the approval of the court having jurisdiction of the action." This provision fixes for New York, in certain terms, the policy that an action once commenced *remains open for intervention* by other shareholders until such time as the court allows its discontinuance, and settles beyond peradventure the rule that out-of-court settlements are invalid as a matter of law (and *clearly* not res judicata). A logical extension of this policy is found in *subparagraph (f)(3) of Section 725*[41a] which disallows any indemnification to directors and officers for expenses incurred in defending or amounts paid in disposing of any pending derivative action without court approval. These provisions will have the sure effect of completing the process begun by *Clark v. Greenberg*[42] of discouraging collusive extra-judicial settlements. The mandatory

38. 268 F.2d 194 (2d Cir. 1959).
39. Id. at 197.
40. 176 Misc. 220, 25 N.Y.S.2d 502 (Sup. Ct. 1940), aff'd, 262 App. Div. 731, 29 N.Y.S.2d 139 (1st Dep't 1941), aff'd, 288 N.Y. 668, 43 N.E.2d 71 (1942).
41. 99 N.Y. 185, 1 N.E. 663 (1885).
41a. See, infra note 344.
42. 296 N.Y. 146, 71 N.E.2d 443 (1947).

requirement under federal Rule 23 (c) that notice of a proposed discontinuance or compromise be given to all shareholders has been varied by paragraph (d) which makes the giving of such notice discretionary "if the court shall determine that the interest of the shareholders or any class will be substantially affected by such discontinuance, compromise or settlement. . . ." Since the notice is customarily given in any case, it is perhaps preferable to allow the court some discretion to eliminate unnecessary expenses where notice is clearly not required.

In *Clark v. Greenberg*,[43] a pending derivative action was discontinued and settled before trial without notice to the shareholders and without court approval. Plaintiff received, by virtue of the settlement, the sum of $9,000 for the transfer and delivery of his stock which had a market value of $51.88. The Court of Appeals, reversing the Appellate Division which had dismissed the complaint in reliance on *Manufacturers Mutual Fire Ins. Co. of Rhode Island v. Hopson*,[44] held that the effect of the *Hopson* case was limited to the right of the plaintiff in a derivative suit to discontinue such suit, but that the essential nature of the derivative suit was such that the recovery of any proceeds therefrom, whether by way of judgment, settlement with court approval, or private settlement was to be impressed with a trust in favor of the corporation, to which the action belonged in the first instance. The requirement of an accounting by the plaintiff "introduces no new element. It simply amounts to a logical application of a fundamental principle inherent in a representative relation. When one assumes to act for another . . . he should be willing to account for his stewardship."[45] *Paragraph (e)* of Section 626 seeks to codify the general principle of *Clark v. Greenberg* and, in addition, restores former Section 61-a of the General Corporation Law[46] in part by providing that upon the successful prosecution of a derivative action or the receipt by plaintiff of a fund as a result of a compromise or settlement, the court may (1) award plaintiff the reasonable expenses, including attorney's fees, of maintaining the action and (2) direct plaintiff to account to the corporation for the remainder of the proceeds received by him as consequence of the action. Some question may arise, in implementing paragraph (e), whether it purported to codify the rule of *Clark v. Greenberg* with respect to the proceeds of a *private settlement.* "Settlement" as used in this paragraph must perforce be construed in terms of the requirement in paragraph (d) that all settlements be court-approved because the very language of the provision relating to settlements in paragraph (e) assumes a court-directed application of the proceeds. Were a different definition of settlement intended in paragraph (e), language appropriate to this purpose would have been utilized. The

43. Ibid.
44. Supra note 40.
45. Supra note 42 at 150, 71 N.E.2d at 445.
46. Repealed by the laws of 1945.

ambiguity is compounded by the failure to include any clarifying comment on *Clark v. Greenberg* in the reviser's note. Paragraph (e) was apparently drafted on the assumption that the rule incorporated in paragraph (d), that all settlements were to be approved by the court, would not be violated. If an out-of-court settlement is made after the effective date of the new law, the question of the residual vitality of *Clark v. Greenberg* in such a context will surely provide grist for the appellate mill.

The last line of paragraph (e) provides that the contents of the paragraph "shall not apply to any judgment rendered for the benefit of injured shareholders only and limited to a recovery of the loss or damage sustained by them." This constitutes a statutory restatement of a line of cases in New York[47] in which the courts, despite the derivative nature of the suit, have tailored the judgment to allow a *pro-rata* award to the innocent plaintiff-shareholders only—to compensate them for their personal injury (rather than a full recovery on behalf of the corporation in which the guilty defendant directors-shareholders might share). Thus, in the now celebrated *Perlman v. Feldmann*[48] the court stated "And plaintiffs, as they contend, are entitled to a recovery in their own right, instead of in the right of the corporation (as in the usual derivative actions), since neither Wilport nor their successors in interest should share in any judgment which may be rendered. . . . Defendants cannot well object to this form of recovery, since the only alternative, recovery for the corporation as a whole, would subject them to a greater total liability."[49] It is, of course, obvious that this type of special recovery will not be tolerated when intervening creditors' rights are involved, and is to be clearly delineated from a recovery obtained by a shareholder as a result of the *direct* action brought in his primary right.

Security for expenses in derivative suits: It is perhaps bromidic to restate the now familiar proposition that Section 61-b of the General Corporation Law, the present "security for expenses" statute, was ushered into the New York Law in 1944 along with its companion piece, the "contemporaneous ownership" rule, to discourage the "strike suit." That this highly controversial piece of legislation performed this office in an exemplary manner is likewise a familiar proposition—although, of course, no one will ever be able to say with any measure of certainty how many legitimate suits were discouraged in the process. The rough edges of the statute were honed to some extent by two developments: first, the decision in *Baker v. McFadden Publications, Inc.*[50] which ameliorated the plight of the benighted less-than-5% shareholder by allowing him, at any

47. See Di Tomasso v. Loverro, 250 App. Div. 206, 293 N.Y. Supp. 912 (2d Dep't 1937), aff'd, 276 N.Y. 551, 12 N.E.2d 70 (1937); Sautter v. Fulmer, 258 N.Y. 107, 179 N.E. 310 (1932); Geltman v. Levy, 11 A.D.2d 411, 207 N.Y.S.2d 366 (1st Dep't 1960); Harris v. Rogers, 190 App. Div. 208, 179 N.Y. Supp. 799 (4th Dep't 1919); see also Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955).

48. 219 F.2d 173 (2d Cir. 1955).

49. Id. at 178.

50. 300 N.Y. 325, 90 N.E.2d 876 (1950).

time during the pendency of the action, to either avoid or vacate an order requiring the posting of a "security for expenses" bond if he could interest other shareholders with the requisite percentage of shares or share-equity to join him in the action; second, a series of lower court decisions, commencing with *Noel Associates, Inc. v. Merrill,*[51] which implemented *Baker v. McFadden* by allowing *non-contemporaneous* owners to intervene in the action and their shares to be counted in determining whether a bond should be posted or vacated. More recently, the Appellate Division, Second Department in the case of *Richman v. Felmus*[52] has disallowed intervention by non-contemporaneous owners for the purpose of determining whether the requirements of Section 61-b have been met. This decision constitutes the only appellate determination of this question and should normally be persuasive, except that in the very latest decision in which the question was raised, *Sorin v. Shamoon Industries,*[53] the Supreme Court, First Department, refused to follow *Richman v. Felmus* and allowed the intervention of non-contemporaneous owners in applying the rule of *Baker v. McFadden.* It is noteworthy that the prefiled (1960) version of the new law incorporated the following provision in the derivative action section: "Holders of shares of the corporation or of voting trust certificates or of beneficial interests in shares may be permitted to intervene as plaintiffs in such action, whether or not they were holders thereof at the time of the wrong complained of." A great deal of opposition developed against the inclusion of this provision in the new law on the ground that it would bring back the "strike suit," and it was eliminated from the bill as finally presented for passage as a result of this pressure. What effect will the elimination from the new law of the attempted codification of *Noel Associates, Inc. v. Merrill* have on the ultimate decision in the Court of Appeals when the question is deliberated there, as soon it must be? One may speculate that it will balance the scales in favor of the view taken in *Richman v. Felmus.*[54] The same paragraph in the (1960) study

51. 184 Misc. 646, 53 N.Y.S.2d 143 (Sup. Ct. 1944).

52. Supra note 30.

53. 30 Misc. 2d 408, 220 N.Y.S.2d 760 (Sup. Ct. 1961). See, also, Perry v. Shahmoon Industries, Inc., 11 Misc. 2d 137, 172 N.Y.S.2d 245 (Sup. Ct. 1958) which allowed intervention. Richman v. Felmus stands as the solitary authority, at the state level, which disallows intervention by non-contemporaneous owners. The trend in the federal courts under Rule 23(b)(1) is to disallow intervention. See on this point Bauer v. Servel, Inc., 168 F. Supp. 478 (S.D.N.Y. 1958); Elkins v. Bricker, 147 F. Supp. 609 (S.D.N.Y. 1956); Kaufman v. Wolfson, 136 F. Supp. 939 (S.D.N.Y. 1955). Contra, Fuller v. American Machine & Foundry Co., 95 F. Supp. 764 (S.D.N.Y. 1951).

54. A number of interesting questions relating to "security for expenses" and intervention by non-contemporaneous owners remain essentially unresolved. Is it sufficient to satisfy the requirements of section 61-b (or N.Y. Bus. Corp. Law § 627) as to one cause of action in a complaint setting forth multiple causes of action? Compare on this point, Richman v. Felmus, supra note 30, with Perry v. Shahmoon Industries, Inc., supra note 53, and Sorin v. Shahmoon Industries, Inc., supra note 53. Further, can the plaintiff escape posting a bond, under the Felmus case, by increasing his own holdings? Compare on this point, Richman v. Felmus, supra note 30, and Purdy v. Humphrey, 187 Misc. 40, 60 N.Y.S. 2d 535 (Sup. Ct. 1946) with Weinstein v. Behn, 68 N.Y.S.2d 199 (Sup. Ct. 1947), aff'd, 272 App. Div. 1045, 75 N.Y.S.2d 284 (1st Dep't 1947), appeal dismissed, 298 N.Y. 506, 80 N.E.2d 656 (1948).

bill version of the new law which contained the foregoing "intervention by non-contemporaneous owners" provision likewise included the following: "For the purposes of section 626 (Security for expenses in shareholders' derivative action) the value of the holdings of the plaintiff or plaintiffs shall be the market value thereof on the day the action is brought. The value of the holdings of the intervenors shall be the market value thereof on the day that intervention is permitted." The elimination of this provision from the new law is rather puzzling since it was an effective restatement of the decisional law of the state as set forth in *Weinstein v. Behn*[55] and more recently in *Sorin v. Shamoon Industries, Inc.*[56] In the *Sorin* case, the court quoted from *Noel Associates v. Merrill*[57] to the effect that " 'the legislature clearly did not intend to have the right to security fluctuate with the market after the action was started.' "[58]

Although the continuing need for a "security for expenses" statute is open to very serious question, particularly in light of the inclusion in the new law of paragraphs (d) and (e) of Section 626 which eliminate for all practical purposes the threat of the "strike suit," the provisions of Section 61-b have been perpetuated in almost their precise form in *Section 627* of the Business Corporation Law. Two changes should be noted: (1) holders of a beneficial interest in shares, included in Section 626 as persons who may bring a derivative action, are added as persons from whom security for expenses may be sought; and (2) a drafting ambiguity in Section 61-b has been corrected by making it clear that security for expenses may be sought from a plaintiff-voting trust certificate holder unless he holds a certificate representing at least five percent of the outstanding shares (of any class). The provision in Section 626 that the plaintiff must hold at least five percent of the outstanding shares (rather than such percentage of the outstanding shares *of any class*) is an oversight which is certain to be corrected at the 1962 legislative session.[58a]

It would appear that Section 627 was not drafted with an eye to the double or multiple derivative action. Such interesting (and complex) questions arise in such suits as whether the plaintiff-shareholder need hold the requisite percentage of shares or equity in the corporation *in whose right* the action is brought where his own corporation has (or doesn't have) sufficient holdings in such other corporation to meet the requirements of the statute, or whether plaintiff-shareholder need only hold the requisite percentage of shares or equity in his own corporation (which is not the corporation in whose right the action is brought), or whether he must meet the requirements of the security for expenses statute as to both corporations.[59] It is rather a pity that an attempt

55. Supra note 54.
56. Supra note 53.
57. Supra note 51.
58. Supra note 53 at 438, 220 N.Y.S.2d at 790.
58a. An amendment to Section 627 incorporating this change was approved at the 1962 session of the legislature.
59. See for interesting discussions of these and other problems involved in multiple

was not made in the new law to resolve these questions, one way or another, although, concededly, the drafting problems would be very knotty. That there was a similar omission to consider the implications of the current Section 61-b for the multiple derivative suit is reflected in *Altman v. Autocar Company*[60] in which plaintiff-shareholders had sufficient holdings in their own corporation to satisfy Section 61-b, but not in the corporation in whose right the action was brought. The court held that the latter corporation could demand security for its expenses in the suit on the ground that the language of Section 61-b clearly required ownership of shares *in the corporation in whose right the action is instituted* (which the court construed to be the corporation whose directors were being sued as the real defendants in the action). It seems very likely that Section 627 will receive a similar construction.

In concluding the discussion of the "security for expenses" area, it is perhaps necessary to comment on the basic proposition that while the small shareholder who cannot meet the requirements of the statute is, unless successful in the suit, saddled with the often enormous expenses of both sides of the litigation (which may include indemnification rights of all defendant directors and officers as well as the expenses of the corporation), the large shareholder who can satisfy the statute will, even if unsuccessful, be obliged to pay only nominal court costs. Although it was suggested in *Neuwirth v. Wyman*[61] that the court has the power, where warranted, to assess larger costs against an unsuccessful plaintiff who controls sufficient equity in the corporation to avoid the consequences of Section 61-b, the unquestionably better view is that taken in *Isensee v. Long Island Motion Picture Co.*[62] that such power does not exist. The apparently unequal treatment of the small shareholder in this respect has been held to present no constitutional difficulties.[63]

B. *The voting right*

The new law provides a comprehensive and detailed treatment of the shareholder's voting rights by which the existing law affecting such rights is retained in some cases, altered in others, and generally expanded.

Qualification of Voters: Section 612 of the Business Corporation Law, dealing with the qualification of voters, is structurally new although it incorporates certain features of Sections 47, 48 and 51 of the New York Stock Corporation Law. The prime qualification, included in *paragraph (a)*, that every share is born with the right to vote unless shorn of that right by provi-

derivative suits: Note, Examination of the Multiple Derivative Suit and Some Problems Involved Therein in Light of the Theory of the Single Derivative Suit, 31 N.Y.U.L. Rev. 932 (1956); Note, Suits by a Shareholder of a Parent Corporation to Redress Injuries to the Subsidiary, 64 Harv. L. Rev. 1313 (1951).

60. 133 N.Y.S.2d 535 (Sup. Ct. 1954).

61. 119 N.Y.S.2d 266 (Sup. Ct. 1953), aff'd, 282 App. Div. 1044, 126 N.Y.S.2d 895 (1st Dep't 1953).

62. 184 Misc. 625, 54 N.Y.S.2d 556 (Sup. Ct. 1945).

63. See Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1949); Lapchak v. Baker, 298 N.Y. 89, 80 N.E.2d 751 (1948).

sion of the certificate of incorporation, retains the existing statutory formulation. Other qualifications (or disqualifications) set forth in the section are not currently embodied in statutory form:

(1) Under *paragraph (b)*, "treasury shares" are neither entitled to vote nor to be counted in determining the total number of outstanding shares. This represents current decisional law as reflected in *Vail v. Hamilton*[64] and similar cases.[65] However, it is important to note the distinction drawn in the *Vail* case between treasury shares treated by the corporation as inactive or retired, and shares reacquired by the corporation which it has pledged as collateral security for a bona fide debt that it owes; in the latter case, the corporate stock may be counted and voted.[66] Quaere, whether this distinction will survive the general disqualification of treasury shares from voting and being counted as outstanding under paragraph (b)?

Paragraph (b) likewise disqualifies from voting "shares held by another domestic or foreign corporation of any type or kind, if a majority of the shares entitled to vote in the election of directors of such other corporation is held by the corporation."[67] This codifies the rule of *Italo Petroleum Corporation of America v. Producers' Oil Corporation*.[68] The extent to which shares of a parent corporation owned by its subsidiary may be counted as outstanding and voted has not been judicially clarified in New York. In *Lazenby v. International Cotton Mills*,[69] the ruling of a referee which sanctioned the voting of the subsidiary corporation's shares was affirmed in the appellate court. However, since the Appellate Division made no specific reference to this question, the *Lazenby* case is at best inconclusive authority. In the recent case of *Dal-Tran Service Co. v. Fifth Avenue Coach Lines, Inc.*,[70] in which the very provision (paragraph (b) of Section 612) under discussion was called to the court's attention for the purpose of establishing that the common law rule authorized the voting of a parent corporation's shares held by a subsidiary in an election of directors of the parent, the lower court rejected *Lazenby* as a controlling precedent. At the appellate level, after stating that *circular voting* is of doubtful validity in New York, the court commented: "Nor, in our view, is *Lazenby v. International Cotton Mills Corp.* clear authority in support of the validity or

64. 85 N.Y. 453 (1881).

65. See Ex parte Holmes, 5 Cow. 426 (N.Y. 1826); Ex parte Desdoity, 1 Wend. 99 (N.Y. 1828).

66. See also Swan v. Stiles, 94 App. Div. 117, 87 N.Y. Supp. 1089 (4th Dep't 1904).

67. Note that under paragraph (g) of Section 612, any other corporation (a majority of whose shares entitled to vote in the election of directors are not owned by the corporation whose directors are to be elected) is free to vote. Was it intended to authorize voting the shares of a subsidiary corporation, less than a majority of whose shares are owned by its holding company, in an election of the directors of the holding company?

68. 20 Del. Ch. 283, 174 Atl. 276 (1934).

69. 174 App. Div. 906, 160 N.Y. Supp. 1 (1st Dep't 1916), aff'd, 226 N.Y. 645, 123 N.E. 875 (1919).

70. 14 A.D.2d 349, 220 N.Y.S.2d 549 (1st Dep't 1961), reversing, 30 Misc. 2d 236, 217 N.Y.S.2d 193 (Sup. Ct. 1961).

the invalidity of circular voting."[71] The general tenor of related precedents would appear to support the principle embodied in paragraph (b) that directors ought not, as a matter of policy, be afforded the opportunity of perpetuating themselves in office by such indirect control of a large block of their corporation's shares.[72]

(2) Under *paragraph (c)*, shares held by an *administrator, executor, guardian conservator, committee* or other *fiduciary* (other than a trustee) may be voted in person or by proxy without registration of such shares on the corporate books. This provision is clearly in line with decisional authority in New York.[73] Shares held by a *trustee* are given somewhat different treatment. They may be voted in person or by proxy *only if the trustee's name has been transferred to the books of the corporation.* This represents the effective rule in New York.[74] The distinction drawn between the legal representative and the trustee in terms of the need for registration is presumably based on the consideration that in the case of the legal representative there is only one person who can effectively exercise the voting right. The testamentary or inter-vivos trustee is not generally in a parallel situation.[75]

It is interesting to observe that legal representatives and trustees are authorized in paragraph (c) to vote by proxy. This would appear to represent a distinct departure from the common law rule affecting fiduciaries. That trustees owe a duty of independent judgment and may not delegate the exercise of such judgment or discretion for which they have assumed personal responsibility is so well established as not to require citation of authority. The voting of shares under a fiduciary's control would surely fall within the general rule and it has been so held.[76] The extent to which statutory sanction of proxy voting by fiduciaries authorizes the delegation of discretionary (as contrasted with purely ministerial or mechanical) duties may not be as clear as appears

71. Id. at 357, 220 N.Y.S.2d at 558.

72. It is to be noted that Section 612 does not include in the category of non-votable shares, shares of its own which the corporation holds in a fiduciary capacity. Such shares were not votable under the New York common law rule (see Ex parte Holmes, supra note 65). It is interesting to observe that such shares were made non-votable under the original Model Act provision (Section 31) but such provision has since been eliminated.

73. See In re Bruder & Son, 302 N.Y. 52, 96 N.E.2d 84 (1950); Benkard v. Leonard, 231 App. Div. 625, 248 N.Y. Supp. 497 (1st Dep't 1931). In both cited cases, it was held that the shares did not have to appear on the books of the corporation in the name of the legal representative.

74. See Benkard v. Leonard, supra note 73.

75. In the case of the inter vivos trustee, the settlor is normally in a position to vote the shares. In the case of the testamentary trustee, there is normally an executor available to represent the estate. See Benkard v. Leonard, supra note 73, where an inter vivos trustee who held shares as security for the performance by decedent of a separation agreement was subordinated in the right to vote such shares to the legal representative of decedent-shareholder's estate.

76. See In re Dodge, 39 N.Y.S.2d 311 (Surr. Ct. 1943), aff'd, 266 App. Div. 845, 132 N.Y.S.2d 315 (1st Dep't 1943), leave to appeal denied, 291 N.Y. 828, 52 N.E.2d 119 (1943); In re Green, 166 Misc. 800, 2 N.Y.S.2d 556 (Sup. Ct. 1937); In re Palmer, 132 N.Y.S.2d 311 (Surr. Ct. 1954); see generally, Allison v. Ver Valen Co., Inc., 170 Misc. 144, 9 N.Y.S. 2d 708 (Sup. Ct. 1939).

on the surface. In Delaware, for example, where voting trustees have been authorized for some time, by statute, to vote by proxy, the courts have tended to give a rather restrictive construction to the statute as being in derogation of common law. *In Brady v. Mexican Gulf Sulphur Company*,[77] a Delaware court refused to construe the voting trust statute as authorizing the creation of an irrevocable proxy and suggested that clear provision for such extensive delegation must be made by the express terms of the voting trust agreement. Although wholesale delegation of fiduciary responsibilities is not, as a matter of policy, to be lightly sanctioned, there is much to be said for statutory authorization of proxy voting by fiduciaries in cases where they do not have the necessary competence to vote in the best interests of their cestuis-que-trust, or in emergencies.

(3) Under *paragraph (d)*, shares held by or under the control of a *receiver* may be voted by him without registration on the corporate books if authorized in the order of the court by which he was designated. The right of a receiver to vote shares held by him in that capacity with court approval has been judicially recognized in New York,[78] although some question exists concerning the voting rights of a receiver in supplementary proceedings.[79]

(4) Under *paragraph (e)*, the *pledgor* shall be entitled to vote the pledged shares until the shares have been transferred into the name of the pledgee or his nominee. This is an effective retention of the provision currently embodied in Section 47 of the New York Stock Corporation Law, under which the pledgor retains the right to vote the pledged shares unless he has relinquished such right under the contract of pledge or has allowed the pledgee to register his name on the corporate books.

(5) Under *paragraph (f)*, special provision is made for the voting disqualification of redeemable shares which have been called for redemption.[80] It is designed to fix the precise time when such shares shall no longer be deemed outstanding and entitled to vote (and, correlatively, have become treasury shares subject to paragraph (b)). This time is set "on or after the date on which written notice of redemption has been sent to holders (thereof) and a sum sufficient to redeem such shares has been deposited with a bank or trust company with irrevocable instruction and authority to pay the redemption price to the holders of the shares upon surrender of certificates therefor." This paragraph admirably serves a practical end. Although no New York case has been found in which the voting rights of redeemable shares (that have been called) has been in issue, the fairly recent case of *Kantor v. Stendig*,[81] in which a lower court held that a derivative action brought by a shareholder, whose

77. 32 Del. Ch. 372, 88 A.2d 300 (1952).
78. See American & British Mfg. Co. v. International Power Co., 173 App. Div. 319, 159 N.Y. Supp. 582 (1st Dep't 1916).
79. In re D. J. Salvatore, Inc., 268 App. Div. 919, 51 N.Y.S.2d 342 (2d Dep't 1944).
80. This provision was borrowed from Section 31 of the Model Act.
81. 190 Misc. 861, 76 N.Y.S.2d 284 (Sup. Ct. 1947).

shares were redeemed and retired during the pendency of the action, was not extinguished by such redemption, points up the desirability of fixing for voting purposes the precise time when shareholder status shall be deemed lost upon a redemption of shares.

(6) Under *paragraph (h)*, the provisions of Section 48 of the New York Stock Corporation Law are retained without any substantive change. It provides, in sum, that when shares are registered on the corporate books in the names of two or more fiduciaries, a majority of them control the voting of the shares unless they shall be evenly decided, in which case any court having jurisdiction of their accounts, upon the petition of any fiduciary or other party in interest, may direct the voting of the shares in the best interest of the beneficiaries. The provision has no application "where the instrument or order of the court appointing such fiduciaries shall otherwise direct how such shares shall be voted." It is very important to note that paragraph (h) retains the provision in Section 48 precluding its application to any fiduciaries designated by "any deed of trust or other instrument" made prior to May 1, 1956 or to shares at any time transferred to or held by fiduciaries so designated. Prior to May 1, 1956, Section 48 in terms applied only to shares that "(have) passed by operation of law or by virtue of any last will and testament" (essentially only to *testamentary* trustees or other fiduciaries); the statute was amended on that effective date to include fiduciaries designated under "any deed of trust or other instrument" (designed to cover inter-vivos trustees, and broad enough to include voting trustees) and expressly barred retroactive application. This paragraph (as did Section 48) changes the common law rule, reflected in *Townsend v. Winburn*,[82] that fiduciaries had to act as a unit,[83] that any disagreement among them prevented the effective voting of the shares they controlled, and that there was no power in the court to vote shares in behalf of fiduciaries who could not agree.[84]

(7) Under *paragraph (i)*, the corporation is protected in treating the persons in whose names shares stand on the books of the corporation as the owners thereof "for all purposes." This latter clause would appear to be stated too broadly—what was undoubtedly intended was to make record ownership the exclusive test for all purposes *of voting*. So understood, this paragraph would retain the essence of Sections 47 and 62 of the New York Stock Corporation Law and Section 164 of the New York Personal Property Law.[85]

82. 107 Misc. 443, 177 N.Y. Supp. 757 (Sup. Ct. 1919).

83. See In re Kirkman, 143 Misc. 342, 346, 256 N.Y. Supp. 495, 501 (Surr. Ct. 1932).

84. Note, National Liberty Insurance Co. v. Bank of America, 126 Misc. 753, 214 N.Y. Supp. 643 (Sup. Ct. 1926) in which the court refused to appoint a successor trustee, where the designated voting trustee was not eligible to act, on the ground that voting trusts were not "true" trusts for this purpose.

85. Note, Flagg-Utica Corporation v. Baselice, 14 Misc. 2d 476, 178 N.Y.S.2d 860 (Sup. Ct. 1958) in which the beneficial (non-record) owner of shares, voting by proxy in favor of a sale of the essential properties of the corporation, was denied an appraisal on the ground that the corporation had the right to rely on record ownership in determining entitlement to vote.

Limitations on the right to vote: Section 613 of the Business Corporation Law implements the skeletal qualification set forth in paragraph (a) of Section 612 that the right to vote is subject to limitations prescribed by the certificate of incorporation. In this, it serves precisely the function performed by the first paragraph of Section 51 of the New York Stock Corporation Law—the provisions being identical in form and substance. The section provides, in sum, that the certificate of incorporation may strip a share of its voting right either absolutely or conditionally or it may otherwise limit or define the respective voting rights of the several classes (or series) of shares. Where such right to vote is so denied or limited, the denial or limitation extends as well to any provision of the chapter which prescribes a specified vote or consent of shareholders for corporate action.[86] So, for example, a shareholder *generally* denied the right to vote by provision of the certificate of incorporation would, as a general rule, not have voting rights in a proposed sale of all or substantially all the corporate assets under Section 909 of the Business Corporation Law, or merger or consolidation under Section 903 thereof.

The denial or limitation of the right to vote by provision of the certificate of incorporation is, under Section 613, expressly made subject to any contrary provision of the chapter. Such "contrary provisions" are found in *Section 804* of the Business Corporation Law. These provide that "notwithstanding any provision in the certificate of incorporation" the holders of shares of a class (or series) shall be entitled to *vote*[87] and to *vote as a class*[88] in any case in which an amendment of the certificate of incorporation would: (1) exclude or limit their right to vote on any matter, except as such right may be limited by voting rights given to new shares then being authorized of any existing or new class (this is the counterpart of the second paragraph of Section 51 of the New York Stock Corporation Law); (2) change, classify or reclassify their shares under *subparagraphs (b), (10), (11) or (12)*[89] *of Section 801* (the effective

86. This provision originated in an amendment, in 1951, to N.Y. Stock Corp. Law § 51. Prior thereto, an express provision in the certificate of incorporation was required to exclude a shareholder's right to vote with respect to any matter for which a special statutory shareholders' consent was prescribed.

87. Shares of any class or series of a class (see N.Y. Bus. Corp. Law § 804(b)) which are adversely affected by the amendment in the manner prescribed in Section 804(a) are authorized to vote on the amendment, whether or not otherwise entitled to vote. In such case, their shares are to be considered for quorum purposes (see N.Y. Bus. Corp. Law § 608) and are to be deemed "outstanding" for purposes of determining whether the requisite majority of the outstanding shares entitled to vote have supported the amendment (see N.Y. Bus. Corp. Law § 803(a)).

88. Shares of any class or series of a class (see N.Y. Bus. Corp. Law § 804(b)) which are adversely affected by the amendment in the manner prescribed in Section 804(a) are likewise authorized to vote as a class on the amendment, whether or not otherwise entitled to vote as a class by the provisions of the certificate of incorporation. In such case, the assent of a majority of the outstanding shares of such class or series is required to validate the amendment.

89. These amendments involve classifications and reclassifications, presently authorized under N.Y. Stock Corp. Law § 35(3), which include such vital changes as the reduction of the par value of authorized shares, the elimination or other adverse affect upon accrued undeclared dividend rights, redemption rights, preemptive rights and the like. Generally

counterpart of the third paragraph of Section 51 of the New York Stock Corporation Law), or provide for the conversion of their shares into shares of another class or series, or alter their existing conversion rights, if any such action would adversely affect such holders; (3) subordinate their rights by authorizing shares having preferences which would be in any respect superior to their rights (the counterpart of the third paragraph of Section 51 of the New York Stock Corporation Law).

Voting trust agreements: *Section 621* of the Business Corporation Law perpetuates the policy in New York of authorizing voting trust "pooling" arrangements by shareholders.[90] It is the counterpart of Section 50 of the New York Stock Corporation Law, construed by the Court of Appeals in *In re Morse*[91] to be a preemptive statute. This case, which presumably will continue to serve as controlling precedent for voting trusts under Section 621 of the new law, held that voting trust agreements do not stand or fall on common law principles (which, in any case, appear never to have definitively settled the question of the validity of such trusts) but are dependent for their validity upon the statute embodying the ostensible public policy of the state in this area. Accordingly, voting trust agreements to be valid must conform strictly to the requirements of the statute which, in terms, authorizes only a transfer to the voting trustee, under such an agreement, of the shareholder's voting rights. Any attempt to vest other facets of the shareholder's beneficial ownership in the voting trustee would apparently invalidate the trust (at least to the extent of the unauthorized vesting).[92] In *In re Bacon*,[93] the Court of Appeals subsequently underlined the rule of strict construction by refusing to imply the right of trustees to vote a (virtual) dissolution of the corporation from the shareholders' transfer, without more, of the right to vote. The Court suggested that the right of trustees to vote a dissolution (or presumably to take any other extraordinary action) would have to be expressly spelled out by the terms of the voting trust agreement.

Certain other basic features of the voting trust concept are invariable and will continue to govern voting trust arrangements adopted pursuant to the new law. It is, for example, axiomatic that the voting trust device be utilized for legitimate ends and not contravene charter or statutory provisions, or con-

speaking, the accomplishment of a change authorized by these subdivisions of Section 801 provides a correlative right of appraisal to the shareholder adversely affected (see N.Y. Bus. Corp. Law § 806(b)(6)).

90. Note, the general "pooling" arrangement, authorized by N.Y. Bus. Corp. Law § 620(a), which provides that shareholders may agree "that in exercising any voting rights, the shares held by them shall be voted as therein provided, or as they may agree, or as determined in accordance with a procedure agreed upon by them."

91. 247 N.Y. 290, 160 N.E. 374 (1928).

92. The Court suggested in the Morse case that components of the shareholder's full share ownership, other than the right to vote, might be validly separated away from his beneficial ownership—but not through the medium of the voting trust. Cf. Brentmore Estates v. Hotel Barbizon, 263 App. Div. 389, 33 N.Y.S.2d 331 (1st Dep't 1942).

93. 287 N.Y. 1, 38 N.E.2d 105 (1941). See also Byington v. Piazza, 131 App. Div. 895 (1st Dep't 1909).

template some oppression or wrong to shareholders or creditors.[94] In *Eisenberg v. Central Zone Property Corp.*,[95] the Court of Appeals recently struck down a voting trust which the majority shareholders sought to impose on the minority shareholders against their will. The court stated that the voting trust was being used in contravention of statute and in violation of the majority shareholders' fiduciary duty to the minority. Other aspects of the voting trust, likewise of continuing applicability under the new law, are such matters as the irrevocability of the voting trust agreement (except perhaps with the unanimous consent of the voting trust certificate holders),[96] the ready transferability of the voting trust certificates,[97] and the removability of derelict voting trustees by proceedings in the supreme court.[98]

The basic structure of Section 621 corresponds very closely to the existing statute in providing for: (1) a written voting trust agreement; (2) a duration for such agreements not to exceed ten years;[98a] (3) the transfer to the voting trustees only of voting rights; (4) the issuance by the voting trustees of voting trust certificates in exchange for the shareholders' shares; (5) the maintenance by the trustees at their office (or at a place designated in the agreement) of correct and complete books and records of account relating to the trust and a record listing the voting trust certificate holders, available for inspection by the certificate holders; and (6) the filing of a duplicate voting trust agreement in the office of the corporation[99] which, along with the record of voting trust certificate holders, shall be available for inspection by shareholders of record and certificate holders (in person or by agent or attorney) in the same manner as are the records of the corporation under Section 624 (the general inspection statute).

However, despite the similarity in basic features between the new statute and the existing one, some important variations are noteworthy:

(a) *The "open-end" voting trust requirement has been eliminated.* Under the current statute "every other stockholder may transfer his stock to the same trustee or trustees and thereupon shall be a party to such agreement." In *In re*

94. See In re Morse, supra note 91 at 298, 160 N.E. at 376, in which the Court stated that the purpose of a voting trust must be legitimate. See Dal-Tran Service Co. v. Fifth Avenue Coach Lines, Inc., supra note 70 at 356, 220 N.Y.S.2d at 557. See generally, Ballantine, Voting Trusts—Their Abuses and Regulation, 21 Texas L. Rev. 139 (1943); Gose, Legal Characteristics and Consequences of Voting Trusts, 20 Wash. L. Rev. 129 (1945).

95. 306 N.Y. 58, 115 N.E.2d 652 (1953).

96. See In re Morse, supra note 91 in which the Court stated that voting trusts are irrevocable for the prescribed duration. Minnesota provides for revocability of voting trusts by the holders of a majority in interest (see Minn. Stat. Ann. § 301.27). See Ballantine, supra note 94 at 153, 164, 165.

97. See Union Trust Co. v. Oliver, 214 N.Y. 517, 108 N.E. 809 (1915).

98. See In re Allen, 178 Misc. 541, 35 N.Y.S.2d 120 (Sup. Ct. 1942), aff'd, 264 App. Div. 764, 35 N.Y.S.2d 717 (1st Dep't 1942), appeal denied, 288 N.Y. 738 (1942).

98a. Note, N.Y. Real Prop. Law § 130(c)(2) providing for a 5-year voting trust.

99. See DeMarco v. Paramount Ice Corp., 102 N.Y.S.2d 692 (Sup. Ct. 1950) holding that a failure to file the voting trust agreement does not invalidate the agreement but merely renders it unenforceable until there has been compliance.

Morse,[100] the Court of Appeals suggested that, quite apart from the express requirement of the statute, such a provision would be indispensable to the validity of a vote-control device like the voting trust because the public policy of the state would not tolerate setting one group of shareholder "ins" against another group of shareholder "outs," thereby creating the possibility of internal corporate dissension. In eliminating the open-end trust requirement, the legislature apparently did not perceive any serious danger of consequent intra-corporate antagonism and was not notably impressed by the court's assessment of policy needs. It was undoubtedly motivated by such considerations as the impact of the Securities Act of 1933 on open-end voting trusts (the voting trustee would be an "issuer" under the Act) and the desirability of allowing this vote-control device (like others) to be governed, in this respect at least, by ordinary contract principles and by the principle of *delectus personarae.*

(b) *The duration of the trust may be extended for an additional period not exceeding ten years by one or more certificate holders, by an agreement in writing at any time within six months before the expiration of the voting trust agreement as originally fixed or as extended under the section.* It is not clear whether the foregoing provision for extending an existing voting trust agreement, set forth in paragraph (d), would otherwise be judicially recognized in light of the tendency to construe voting trust statutes strictly.[101] In *Kittinger v. Curchill Evangelistic Ass'n, Inc.*,[102] a provision in a voting trust agreement authorizing the voting trustees to extend the voting trust arrangement for an additional ten-year term was held invalid, the court sustaining the validity of the agreement for the authorized ten-year period.[103] In another case,[104] an attempted *oral* extension of a voting trust agreement was assumed to be invalid. Since the agreement may be extended by less than all of the original parties thereto, paragraph (d) provides additionally that the extension agreement shall not affect the rights or obligations of persons not parties to it.

Various provisions affecting voting trusts have been incorporated into other sections of the new law. These provisions are mainly declaratory of rights recognized judicially.

(a) Under *paragraph (b) of Section 624* voting trust certificate holders are expressly declared to be shareholders under that section, entitled to inspect the general books and records of account, minutes and stock book of the corporation.[105] The right to such an inspection had been recognized by the Court

100. Supra note 91.
101. See In re Morse, supra note 91; DeMarco v. Paramount Ice Corp., supra note 99.
102. 151 Misc. 350, 271 N.Y. Supp. 510 (Sup. Ct. 1934), aff'd, 244 App. Div. 876, 281 N.Y. Supp. 680 (4th Dep't 1944).
103. For the proposition that the voting trust will be sustained for the permissible period, see, also, Mannheimer v. Keehn, 41 N.Y.S.2d 542 (Sup. Ct. 1943); same opinion, officially reported, 30 Misc. 2d 584 (1962), modified, 268 App. Div. 813, 102 N.Y.S.2d 698 (4th Dep't 1944).
104. Wygood v. Makewell Hats, 265 App. Div. 286, 38 N.Y.S.2d 587 (1st Dep't 1942), motion dismissed, 290 N.Y. 656, 49 N.E.2d 619 (1943).
105. Some conflict appears in the cases as to whether the right to inspect the voting

of Appeals in *In re Zlota Baczkowska v. 2166 Operating Corp.*[106]

(b) Under *Section 626* and *paragraph (b) of Section 720,* voting trust certificate holders are included among the persons authorized to sue derivatively. Their right to do so has likewise been judicially sustained.[107]

(c) Although no explicit reference to voting trustees is made therein, it is inferable that voting trustees come within the terms of *paragraph (c) of Section 612* which authorizes shares held by a *trustee* and registered in his name to be voted in person or *by proxy.* The implications of authorizing a trustee to delegate his voting rights have been previously discussed under the "qualification of voters" heading. As indicated in a previous discussion under the same heading, it is likewise quite clear that voting trustees are governed by *paragraph (h) of Section 612* dealing with the subject of deadlock among fiduciaries in the voting of shares under their control.

Proxies: Section 609 of the Business Corporation Law deals with the mechanics of the *proxy*—the "heartbeat" of the modern corporate complex.[108] It restates, *without significant substantive change,* existing statutory provisions in Section 19 of the New York General Corporation Law and Sections 47 and 47-a of the New York Stock Corporation Law dealing with the mechanics of voting by proxy. The section contains the familiar provisions that: (1) every shareholder entitled to vote (or to register assent or dissent without a meeting) may vote by proxy signed by him or his attorney-in-fact; (2) the maximum duration of a proxy shall be eleven months unless otherwise provided in the proxy; (3) the proxy shall be revocable at the pleasure of the shareholder issuing it, subject to paragraphs (f) and (g) (dealing with subject of irrevocable proxies); (4) authority to exercise a proxy shall not be revoked by the death of the issuing shareholder unless prior to its exercise the corporation receives *written* notice of such death;[109] (5) except as otherwise provided in a written agreement, a pledgee who is registered on the corporate books shall

trust "stock" book is an absolute or qualified right. Compare, Bresnick v. Saypol, 57 N.Y.S.2d 904 (Sup. Ct. 1945), modified on other grounds, 270 App. Div. 837, 61 N.Y.S.2d 376 (1st Dep't 1946) in which the right was held to be qualified with In re Spanierman, 58 N.Y.S.2d 322, aff'd, 269 App. Div. 1023, 59 N.Y.S.2d 400 (1st Dep't 1946) holding that general good faith need not be shown—but only compliance with the conditions imposed by the statute itself. See, for a basic discussion of this conflict, the section in this paper dealing with the right of inspection.

106. 279 App. Div. 775, 109 N.Y.S.2d 348 (1st Dep't 1952), aff'd, 304 N.Y. 811, 109 N.E.2d 470 (1952). Note, N.Y. Bus. Corp. Law § 1316 which makes special provisions for the inspection of the voting trust "stock" book in foreign corporations.

107. See Hayman v. Morris, 36 N.Y.S.2d 756 (Sup. Ct. 1942).

108. This paper is not the proper occasion for an extended discussion of the revolutionary role played by the proxy in the development of the modern corporation. For excellent materials and discussion of this area, see Baker & Cary, Corporations 157-248 (3d ed. 1959). Attention is directed to Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E.2d 291 (1955) for the New York view on the allocation of the expenses of a proxy contest (including a discussion of the availability of corporate funds for the reimbursement of the expenses of successful insurgents).

109. This provision changes the existing statute which provides that death shall not revoke a proxy unless the corporation receives either written notice or "through an officer or director, has actual knowledge of such death."

issue a proxy to the pledgor upon demand; and (6) no shareholder shall sell his vote or issue a proxy for any sum of money or anything of value except as authorized in paragraph (f) (dealing with irrevocable proxies) or Section 620 (dealing with agreements between shareholders as to voting, and control of directors).

Paragraphs (f) and (g) deal with the subject of irrevocable proxies and effectively retain the substance of Section 47-a[110] of the New York Stock Corporation Law. Irrevocable proxies, not recognized in New York judicially, are authorized to be issued to: (1) a pledgee; (2) a purchaser of the shares; (3) a creditor who extends or continues credit to the corporation in consideration thereof; (4) a person in exchange for services contracted as an officer of the corporation; and (5) a person designated under an agreement as to voting of shares pursuant to paragraph (a) of Section 620.[111] *Paragraph (g)* declares that such irrevocable proxies shall become revocable after the pledge is redeemed, the contract of sale performed, an agreement relating to voting of shares terminated and, after a maximum period of three years, where the proxy was issued in consideration for extending or continuing credit to the corporation or the performance of services as an officer of the corporation. Under *paragraph (h)*, continuing a parallel rule under Section 47-a of the New York Stock Corporation Law, an irrevocable proxy may be revoked by a subsequent purchaser without notice of its existence, unless the fact that there is an outstanding irrevocable proxy appears plainly on the certificate representing the share.

Cumulative voting: Section 618 of the Business Corporation Law, dealing with the subject of cumulative voting in the election of directors, is identical in both form and substance with Section 49 of the New York Stock Corporation Law. It is mainly notable that New York policy has remained constant in this area in two important respects: first, the adoption of the cumulative voting device in aid of minority shareholder representation on the board remains *optional*[112]; and, second, it can be made available only by provision in the certificate of incorporation; a by-law provision therefor will not suffice,[113]

110. Ushered into the New York law in 1953 under a recommendation of the Law Revision Commission (see N.Y. Law Rev. Comm'n Rep. 1953 Legis. Doc. No. 65(G) 233-262). New York courts had rejected the doctrine, prevailing in some states, of the irrevocable proxy "coupled with an interest" (see In re Germicide Co., 65 Hun 606, 20 N.Y. Supp. 495 (1st Dep't 1892); Sullivan v. Parkes, 69 App. Div. 221, 74 N.Y. Supp. 787 (1st Dep't 1902). But cf. Hey v. Dolphin, 92 Hun 230, 32 N.Y. Supp. 627 (4th Dep't 1895).

111. This constitutes the sole variation from the existing statute, and is made necessary by the new vote-pooling arrangement provided under Section 620(a).

112. Cumulative voting is made mandatory in a large number of states by constitutional provision (13 states) and by statute (7 states).

113. See Thistlewaite v. Thistlewaite, 200 Misc. 64, 101 N.Y.S.2d 679 (Sup. Ct. 1950); In re Schack (Crown Heights Hosp.), 183 Misc. 563, 49 N.Y.S.2d 658 (Sup. Ct. 1944). Note the interesting case of In re Rogers Imports, Inc., 202 Misc. 761, 116 N.Y.S.2d 106 (Sup. Ct. 1952), aff'd, 282 App. Div. 940 (1st Dep't 1953) holding that the adoption of a provision in the certificate of incorporation for cumulative voting had the effect of overriding an existing by-law which authorized a majority of the shareholders to remove a director without cause. These provisions being incompatible, the by-law had to give way.

although in *Daum v. Kinsman (In re American Fibre Chair Seat Corp.)*,[114] the Court of Appeals supported the right of a shareholder to vote cumulatively in an election of directors, where prior thereto the shareholders had unanimously adopted a by-law resolution providing for cumulative voting but the corporate officers had neglected to file the necessary amendment to the certificate of incorporation.

Familiar techniques for diluting cumulative voting strength (such as, the use of the staggered board;[115] extending the term of directors beyond a year; filling vacancies by board action; removal of directors) have been recognized and countered in the new law in the following practical and balanced manner;[116]

(a) *Paragraph (a) of Section 703* provides for the election of directors for a term of one year, except as authorized in Section 704 (dealing with classification of directors).

(b) *Paragraph (a) of Section 704* provides that no class in a staggered board shall include less than three directors. This provision is perhaps a preferable substitute for the Model Act provision that there shall be no classification unless the board consists of at least nine members, and is aimed at making it possible for a substantial minority group to elect a representative at each annual meeting at which a class in a staggered board is up for election. It is almost too obvious to require statement that no minority group, however large, can elect a representative on the board when only two directors are to be elected.[117]

Paragraph (c) of Section 704 provides that where the board is staggered, and the number of directors is increased by the board (through by-law action authorized under paragraph (b) of Section 702) and such newly created directorships are then filled by the very board that voted the increase (as authorized under paragraph (a) of Section 705), there shall be no classification of the additional directors until the next annual meeting of shareholders. This provision is designed to preclude any possible manipulation by directors of the constitution of the board for an extended period so as to deprive shareholders (particularly minority shareholders exercising cumulative voting rights) of the most prized prerogative of share ownership—the selection of corporate managers.

(c) Under *subparagraph (c) (1) of Section 706*, removal of directors, whether with or without cause, is subject to the qualification that where provi-

114. 265 N.Y. 416, 193 N.E. 253 (1934).

115. Where cumulative voting is guaranteed by constitutional provision, a serious constitutional question may arise as to the validity of a statute authorizing the use of the staggered board device (see Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955). But cf. Janney v. Philadelphia Transportation Co., 387 Pa. 282, 128 A.2d 76 (1956).

116. It is recognized that there is really no adequate method of protecting cumulative voting except by making it mandatory (which permits the least amount of dilution).

117. Note the discussion of the mechanics of cumulative voting in Baker and Cary, supra note 108 at 203. See Williams, Cumulative Voting For Directors (1951).

sion for cumulative voting has been made: (1) no director may be removed *by the shareholders* when the number of shares voted against the removal in the proceedings therefor would have been sufficient, if voted cumulatively, to have elected such director in an election of directors at which the same total number of shares were voted and the entire board were being elected; and (2) no director can be removed *by the board* (as authorized under paragraph (a) of Section 709).

C. *Right to receive payment for shares—the "right of appraisal"*

Occasions for its exercise: When purchasing his share interest in the corporation, the shareholder is presumed to contract with a view to the existing body of state statutes affecting corporations, whether found in the general corporation laws or elsewhere under state law, and subject, as well, to the state's reserve power to amend or abolish any such statute. If the governing body of statutes are in all respects legal and the reserve power is exercised conformably with due process requirements, the shareholder's rights can be substantially and vitally affected by the corporation without entitling the shareholder to any corresponding ameliorative.[118] However, New York has for many years chosen to provide shareholders entitled to vote, whose contracts have been affected qualitatively by certain corporate actions, with the alternative of accepting the changed status and remaining in corporation solution or of being "bought out" by receiving payment of the fair value of their shares, traditionally known as the "right of appraisal."[119] This right of appraisal would appear to be purely a creature of statute and to depend for its existence upon the legislative grant.[120] There is no concrete evidence in the New York cases that such right may be granted, in the absence of statute, in the exercise of the equity powers of a court. It has been held, accordingly, that the legislatively created right of appraisal must be strictly construed and that a very close adherence by the courts to the precise terms of the statute is required.[121] When statutorily provided, the right of appraisal generally constitutes the shareholder's *exclusive* remedy.[122] The remedy is not exclusive, however, where elements of fraud, bad faith and overreaching by directors or shareholder majorities are present,

118. See Garzo v. Maid of Mist Steamboat Co., 303 N.Y. 525, 104 N.E.2d 887 (1952).

119. The shareholder must be a "bona fide" one who does not purchase shares for the purpose of harassing the other shareholders. It has been rather clearly held that one who acquires his shares after notices have been sent of the shareholders' meeting, at which action on a matter (subject to appraisal rights) is to be considered, will not be entitled to appraisal (see In re Leventall, 241 App. Div. 277, 271 N.Y. Supp. 493 (1st Dep't 1934); Dynamics Corporation of America v. Abraham & Co., 4 Misc. 2d 50, 152 N.Y.S.2d 807 (Sup. Ct. 1956), modified, 1 A.D.2d 1005, 153 N.Y.S.2d 533 (1st Dep't 1956); Application of Stern, 82 N.Y.S.2d 78 (Sup. Ct. 1948); Flagg-Utica v. Baselice, supra note 85.

120. Garzo v. Maid of Mist Steamboat Co., supra note 118.

121. In re McKinney, 306 N.Y. 207, 117 N.E.2d 256 (1954); In re Marcus (R. H. Macy & Co.), 297 N.Y. 38, 74 N.E.2d 228 (1947); Anderson v. International Mineral & Chemical Corp., 295 N.Y. 343, 67 N.E.2d 573 (1946).

122. Beloff v. Consolidated Edison Co. of New York, 300 N.Y. 11, 87 N.E.2d 561 (1949); Anderson v. International Mineral & Chemical Corp., supra note 121; Blumenthal v. Roosevelt Hotel, 202 Misc. 988, 115 N.Y.S.2d 52 (Sup. Ct. 1952).

or where the statutory procedures for appraisal are disregarded; in such case, an injunction or action to set aside a consummated appraisal would be available.[123]

While it has been suggested that the grant of the right of appraisal may remove any doubts concerning the constitutionality of some of the more radical changes in the shareholder's contract authorized by the 1943 amendment to Section 35 of the New York Stock Corporation Law (*and perpetuated in the new business corporation law*)[124] the view has been expressed that the grant of such right will neither validate nor render constitutional acts which in the absence thereof would violate due process. In *Garzo v. Maid of Mist Steamship Co.*,[125] the Court of Appeals raised this question and expressly left it open because the change involved in that case was "not so 'organic' or fundamental as to give rise to constitutional doubt." One of the more radical amendatory changes authorized—the elimination of accrued *undeclared* dividend rights—was sustained in *McNulty v. W. J. Sloane*[126] as to its validity and constitutionality in a comprehensive review of the effect of the 1943 amendment to Section 35. The subsequent case of *Arstein v. Robert Reis & Co.*,[127] in which an amendment eliminating accrued undeclared dividend rights was sustained in the lower court on the authority of *McNulty v. W. & J. Sloane*, was carried to the United States Supreme Court on a constitutional ground but certiorari was denied.

Although in the case of an elimination of accrued undeclared dividend rights, the shareholder was held in the *McNulty*[128] case to be entitled to a right of appraisal on the ground that the preferential rights of his outstanding shares having preferences were adversely affected, other extreme changes in preferential rights effected by amendments have been held not to entitle the shareholder so affected to an appraisal of his shares. In *In re Dresser*,[129] an amendment that superimposed a new class of shares having preferences superior to those of an existing class of preferred shares was held not to alter the existing shareholders' preferential rights and *no right of appraisal was available.* The rationale for the affirmance of this case without opinion by the Court of Appeals was supplied in the subsequent case of *In re Silberkraus*.[130] The Court there explained that "[T]he right is distinct from the value of the right" and

123. Eisenberg v. Central Zone Property Corp., 306 N.Y. 58, 115 N.E.2d 652 (1953); Brown v. Ramsdell, 227 App. Div. 224, 237 N.Y. Supp. 573 (4th Dep't 1929); In re Drosnes, 187 App. Div. 425, 175 N.Y. Supp. 628 (1st Dep't 1919); see also Starrett Corp. v. Fifth Ave. & Twenty-Ninth St. Corp., 1 F. Supp. 868 (S.D.N.Y. 1932).

124. N.Y. Bus. Corp. Law § 801(9),(10),(11).

125. Supra note 118.

126. 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945).

127. 77 N.Y.S.2d 303 (Sup. Ct. 1948), aff'd, 273 App. Div. 963, 79 N.Y.S.2d 314 (1st Dep't 1948), leave to appeal denied, 298 N.Y. 931, 81 N.E.2d 335 (1948), cert. denied, 335 U.S. 860 (1948).

128. Supra note 126.

129. 221 App. Div. 786, 223 N.Y. Supp. 864 (4th Dep't 1927), aff'd, 247 N.Y. 553, 161 N.E. 179 (1928).

130. 250 N.Y. 242, 165 N.E. 279 (1929).

that the right of appraisal is available only when the "right" as distinguished from the "value of the right" is affected by the amendment. But, as held in the *Dresser* case, the mere creation of a new class of shares with prior preferences to those of an existing preferred class, although it may affect the value of the rights of shareholders of the existing class, *does not alter the right itself.* "The old preferred," declared the court, "was not retired nor, in principle at least, were the preferential rights displaced." The situation is different, however, when the amendment, in addition to creating a new class of preferred stock, *entirely eliminated the old class*; upon retirement of the old class of shares, their preferential rights fall. "Abolition is alteration," said the court, and in such case, *the right of appraisal exists.* In *In re Kinney*,[131] the Court of Appeals reaffirmed, extended and further clarified the rule of the *Silberkraus* case. In this case, a reclassification of the capital stock structure of the corporation involved the creation of a new preferred class of shares with prior preferences over existing preferred shares as to dividends and distribution of assets upon liquidation (despite the existence of accrued undeclared dividend claims of existing cumulative preferred shares), and the reduction of stated no-par value common shares of $10 stated value to par value shares of $1 par value. The Court declared that the legislature had authorized appraisal rights "where an alteration changed the preferential rights within the corporation as between different classes of shares." *If there is no change in the relationship of existing outstanding classes, the fact that both are subjected to a new class with prior preferences does not involve a violation giving rise to the right of appraisal.* No alteration of a preferential right occurs where, as between the different classes of outstanding shares, such rights as previously existed "are left unchanged as between themselves, but are made subject to a new issue of stock." *In re Silberkraus* was likewise clarified with respect to when an alteration can be said to "adversely affect" the preferential right. Here the Court appeared to shift ground considerably for it now took the different position that questions of benefit or detriment were not relevant,[132] but only the essential question of whether the relative preference positions of existing outstanding classes would be affected by the amendment; find such an affect—and the preferential right is altered irrespective of whether the change produces beneficial results. As regards the amendment reducing the stated value of the no-par value shares, the Court held that the preferential rights of the shareholders having preferences had been adversely affected on the theory that prior to the reduction the existing preferred shares were in position to benefit from the earning power of the enhanced capital; that this was not the case after the

131. 279 N.Y. 423, 18 N.E.2d 645 (1929).

132. In the Silberkraus case, the court had stated that:

When as a matter of law, the conclusion cannot be avoided that the alteration has produced advantages to the outstanding shares, the holder might not become entitled to purely theoretical relief. When, however, the result of the alteration is not clear, the wishes of the stockholder rather than the conception of the courts should prevail.

reduction of capital since the fund so obtained, being available for distribution as dividends, the "cumulative preferred stock had lost its right to rely upon this portion of the capital." This complex of cases beginning with *In re Dresser*[133] and culminating in *In re Kinney*,[134] decided prior to 1943, reflect the current rule in New York unless the 1943 amendments to Sections 35 and 38 of the Stock Corporation Law were intended to overrule them. There is no indication of any such intention—indeed, objective proof that these authorities were not intended to be disturbed by such amendments appears from a consideration of the 1951 amendment of Section 51 of the New York Stock Corporation Law. That amendment grants voting rights to any class of shares without voting rights that is adversely affected by (1) an amendment reclassifying the stock structure of the corporation and (2) *to any class of share having preferences that will be subordinated by the authorization of shares having prior preferences.* This would appear to be clear legislative recognition of the continuing authority (as of 1951) of the *Kinney* case—for otherwise there would be no need to delineate a second category of subordinated preferences (which would ostensibly be subsumed under the first category of shares of a class adversely affected by a reclassification pursuant to subdivision three of Section 35 of the Stock Corporation Law). Recent lower court cases continue to rely on *In re Kinney* as a controlling precedent.[135]

The foregoing rather extended (although necessarily incomplete) recital of the current body of *substantive* law affecting the right of appraisal is motivated by the circumstance that, with but limited exceptions, it has been carried over and will remain effective under the new law. Hence, the right of appraisal is granted, as under existing law, in the case of merger,[136] consolidation[137] and transactions involving all or substantially all the corporate assets, not made in the regular course of the business actually conducted by the corporation[138] (*Section 910* of the Business Corporation Law); the sale during liquidation (after dissolution) of all or part of the remaining assets (after paying or adequately providing for corporation liabilities) for securities (or a combination of cash and securities) and a distribution of such securities among the shareholders according to their respective interests[139] (*subparagraph (a) (3) (A)*

133. Supra note 129.
134. Supra note 131.
135. See Brill v. Blakely, 281 App. Div. 532, 120 N.Y.S.2d 713 (1st Dep't 1953); Sterling v. 16 Park Avenue, 132 N.Y.S.2d 921 (Sup. Ct. 1954), modified, 284 App. Div. 1033, 136 N.Y.S.2d 363 (1st Dep't 1954); Standard Brewing Co. v. Peachey, 202 Misc. 279, 108 N.Y.S.2d 583 (Sup. Ct. 1951). It is well to note two changes made, in 1943, in N.Y. Stock Corp. Law § 38(11)(a) which provides appraisal right when preferential rights are altered or abolished: (1) it was made applicable only to shares "having preferences" (these include only preferred shares under N.Y. Stock Corp. Law § 11); (2) the preferred shareholders must be "adversely affected." Both of these changes have been carried over into the new law (see N.Y. Bus. Corp. Law § 806(b)(6)(A)).
136. See N.Y. Stock Corp. Law § 85(7).
137. See N.Y. Stock Corp. Law § 87, 91(7).
138. See N.Y. Stock Corp. Law § 20.
139. See N.Y. Stock Corp. Law § 105(9).

of Section 1005); amendments to the certificate of incorporation, adversely affecting the holder of shares, which alter or abolish (a) any preferential right of outstanding preferred shares, (b) any provision or right in respect of the redemption of outstanding shares (or in the event of the *creation* of such provision or right), (c) any preemptive right to acquire shares or other securities; and (d) an amendment which excludes or limits the right of a holder to vote on any matter, except as such right is limited by voting rights given to new shares then being authorized of any existing or new class[140] (*subparagraph (b) (6) of Section 806*). Likewise, under *paragraph (k) of Section 623*, the right of appraisal is made *exclusive*, except that the shareholder may bring an appropriate action to obtain relief on the ground that the action taken is illegal or fraudulent.[141] *Section 910* further retains existing law by providing that only shareholders entitled to vote may claim appraisal rights[142] (with the single exception in the case of a parent-subsidiary merger under *Section 905* where, although no shareholder authorization is required for the merger, an objecting shareholder of the subsidiary corporation is entitled to appraisal rights).[143] Other rules affecting appraisal, of purely judicial origin, will unquestionably continue to have vitality under the new law to the extent that there is no evidence of a legislative intention to overrule them.[144]

Only two substantive variations from existing appraisal rights appear to have been engendered by the new law:

(1) The right of appraisal currently available to an objecting shareholder under Section 14 of the New York Stock Corporation Law in the event that his preemptive right has been disturbed by the creation of an employee stock purchase plan has been eliminated. Under the formulation in the new law, unless otherwise provided by the certificate of incorporation, no preemptive right is available where shares are issued to directors, officers or employees pursuant to paragraph (d) of Section 505 (*subparagraph (e) (2) of Section 622*); but under *paragraph (d) of Section 505*, there has been substituted for the right of appraisal the requirement that, if the certificate of incorporation preserves the preemptive rights of shares in such case, the issue of "incentive" rights or options to directors, officers or employees of a corporation, or a subsidiary or affiliate thereof, to purchase shares shall be authorized by a majority of all the outstanding shares of such corporation entitled to vote *and* a majority of the

140. See N.Y. Stock Corp. Law § 38(11).
141. See supra note 123 for authorities there cited.
142. In re Harwitz (Republic Pictures Corp.), 192 Misc. 91, 80 N.Y.S.2d 570 (Sup. Ct. 1948). It is well to note in this context that under N.Y. Stock Corp. Law § 51 (also N.Y. Bus. Corp. Law § 804(a)) a shareholder, not otherwise entitled to vote, may become entitled to vote (and, hence, to the right of appraisal) if pursuant to an amendment therein described his rights are adversely affected.
143. This perpetuates the existing provision embodied in N.Y. Stock Corp. Law § 85(7).
144. For example, the rule that shareholders not of record may exercise appraisal rights (see In re Bacon (Susquehanna Silk Mills) supra note 93; Matter of Deutschmann, 281 App. Div. 14, 116 N.Y.S.2d 578 (1st Dep't 1952); Blumenthal v. Roosevelt Hotel, supra note 122).

shares entitled to exercise the preemptive rights (such vote to operate as a release of such preemptive rights).

(2) Under *subparagraph (a) (2) of Section 910*, upon a transaction involving the disposition of all or substantially all of the corporate assets, not in the regular course of the business actually conducted by the corporation, the right of appraisal otherwise granted under Section 910 to non-assenting shareholders will not be available where the transaction is *wholly for cash* and the shareholders' authorization thereof is conditioned upon the distribution of all the net proceeds of such transaction to the shareholders according to their respective interests within one year after the date of the transaction and is likewise conditioned upon the (prior or subsequent) dissolution of the corporation. This change was induced by two considerations: first, to provide a statutory basis at the state level for the tax advantages accruing under Section 337 of the Internal Revenue Code from a sale or exchange of corporate assets and the distribution of the net proceeds thereof to the shareholders in complete liquidation within a twelve-month period thereafter; and, second, to equate the appraisal consequences of such a transaction (as is described above) with the precisely parallel circumstances of the ordinary dissolution and liquidation wherein no appraisal rights are accorded.

Procedure to enforce shareholders' right to receive payment for shares: Under *Section 623* of the Business Corporation Law, important changes have been effected in existing law in the manner of enforcing an available right of appraisal—although in its main outlines the procedure under the new law is similar to Section 21 of the New York Stock Corporation Law, its current counterpart.

(a) Perhaps the most significant departure from the present appraisal procedure is the requirement that the shareholder seeking appraisal file with the corporation not only a written *notice of objection* to the proposed action, at or prior to the meeting at which shareholder approval is sought (*paragraph* (*a*)), but also *notice of election to claim dissenter's rights* (*paragraph* (*c*)) after such shareholder approval has been obtained and notice of this fact has been given by the corporation to each shareholder with a right to dissent (paragraph (b)). The purpose of this dual filing requirement is (by the notice of objection) to give the corporation the basis for an early assessment of the initial reaction of the shareholders to the proposed action, its likelihood of success and the advisability of scrapping it entirely or making necessary adjustments, and (by the notice of election to claim dissenter's rights) to postpone the decision to seek an appraisal until after the shareholders have had an opportunity for fuller consideration at the shareholders' meeting of the factors involved in the proposed action. Under present procedure, the claim for an appraisal accompanies the notice of objection filed prior to the shareholders' meeting.

(b) The section clarifies an area that is left to conjecture under the present statute by providing that a shareholder must dissent, if at all, as to all shares registered in his name of which he is the beneficial owner. In the case of a nominee or fiduciary, non-beneficial owners of record, a dissent filed by such nominee or fiduciary in behalf of a particular beneficial owner whom he represents must be as to all the shares of such owner, although the nominee or fiduciary who represents more than one beneficial owner need not, if he wishes to dissent on behalf of any such owner, file dissents for the remaining owners (paragraph (d)).

(c) Initial responsibility is placed upon the corporation to initiate judicial proceedings for appraisal in the event extra-judicial agreement on the value of the shares cannot be reached (*subparagraph (h) (1)*). The shareholder is authorized to commence such proceedings only upon the failure of the corporation to do so within the prescribed period of time (*subparagraph (h) (2)*). This varies existing procedure and is motivated by the desirability of forestalling multiple shareholder actions (normally consolidated in any case). Should the corporation fail to assume its responsibility to commence the proceedings, the penalty provided is that the court may consider such failure as a factor in assessing the costs and expenses of the proceeding against the parties (*subparagraph (h) (7) (C)*). All shareholders who have filed notices of election to claim dissenter's rights (and who have not settled with the corporation) must be made parties to the proceeding, which is thereby converted into an action quasi-in-rem against their shares. The jurisdiction of the court is plenary and exclusive (subparagraph (h) (3)).

(d) A qualitative variation from existing law is found in *paragraph (j)* which authorizes the satisfaction of appraisal rights from any corporate funds *unless the corporation is insolvent or would be rendered insolvent thereby.* Under existing procedure, "capital impairment" rather than equity insolvency is the standard for satisfaction of appraisal rights and the corporation is authorized to invade capital for such purpose to the extent only of the capital represented by the shares so appraised—so that "the effect of any such purchase . . . shall not be to reduce the actual value of the assets of the corporation to an amount less than the total amount of its debts and liabilities, plus the amount of its capital so applied" (Section 21(2) of the New York Stock Corporation Law). If the corporation is insolvent (*i.e.,* unable to pay debts as they become due in the usual course of its business)[145] when the right to appraisal is established, *paragraph (j)* makes detailed provision for such eventuality which, generally, allows the shareholder to withdraw his notice of election (and be restored to his status as a shareholder with the consequences set forth in *paragraph (e)*), or to retain his status in the corporation with prescribed consequences. The shift to the "insolvency" standard, coordinating Section 623 with a parallel provision in *subparagraph (b) (3) of Section 513,* reflects a legislative policy to allow minority shareholders to "buy-out" of a

145. See for the statutory definition of insolvency, N.Y. Bus. Corp. Law § 102(8).

corporation whenever they dissent from some extreme action taken by the majority shareholders, even though the buy-out may involve utilizing the capital contribution of such majority shareholders. One can hardly cavil at such a policy.

(e) The right of appraisal has a very narrow application to foreign corporations under the new law. It is in terms applicable to such corporations only in the case of merger or consolidation (*paragraph* (*m*)). Even in such case, however, a duty is imposed upon a surviving or consolidated corporation, which is, or is to be, formed under the law of a foreign jurisdiction, to satisfy any appraisal rights arising by virtue of such merger or consolidation in favor of dissenting shareholders of constituent *domestic* corporations only (*subparagraph* (*d*) (*2*) (*D*) *of Section 907*). The appraisal rights of shareholders of constituent *foreign* corporations will presumably depend upon the domiciliary law of the surviving or consolidated corporation (or perhaps of the particular foreign corporation involved if it is not the surviving or consolidated corporation).

Section 623 provides that the shareholder is entitled upon appraisal to the "fair value" of his shares (*paragraph* (*g*); *subparagraph* (*h*) (*4*)) but does not provide any definitive clue as to the standard for appraising such value, except for the suggestion that it shall be determined "as of the close of business on the day prior to the shareholders' authorization date, excluding any appreciation or depreciation directly or indirectly induced by such corporate action or its proposal." The appraiser is alerted against considering an artificial market reaction to the proposed action in estimating the value of the shares. In *In re Fulton*,[146] the Court of Appeals held that there is no one factor which alone controls the determination of fair value. Market quotations, while not necessarily decisive, are entitled to great weight where there is a free and open market on a recognized exchange, and the volume of the transactions and the surrounding circumstances make such market value a fair reflection of the judgment of informed buyers and sellers.[147] Where the shares are not listed on any exchange but are bought and sold in the over-the-counter market, market price is a less reliable index because unlisted stock transactions are not recorded nor subject to regulation and control; all that is available as a matter of record are the "bid" prices which vary considerably from the "asked prices." Hence, in such case, market price should not constitute a controlling factor in the determination of fair value.[148] Under the influence of *In re Fulton*,[149] the

146. 257 N.Y. 487, 178 N.E. 766 (1931). See for a good discussion of evaluation for share appraisals, Note, 6 Brooklyn L. Rev. 86 (1949).

147. In re Kaufman, Alsberg & Co., 15 A.D.2d 468, 222 N.Y.S.2d 305 (1st Dep't 1961); In re Deutschmann (American Tel. & Tel. Co.), 281 App. Div. 14, 116 N.Y.S.2d 548 (1st Dep't 1952); In re Marcus (R. H. Macy & Co.), 191 Misc. 808, 77 N.Y.S.2d 529 (Sup. Ct. 1948), modified, 273 App. Div. 275, 79 N.Y.S.2d 76 (1st Dep't 1948), aff'd, 302 N.Y. 881, 100 N.E.2d 55 (1951); In re Behrens, 183 Misc. 736, 61 N.Y.S.2d 179 (Sup. Ct. 1946), aff'd, 271 App. Div. 1007, 69 N.Y.S.2d 910 (1st Dep't 1961).

148. In re Silverman (Hoe & Co.), 282 App. Div. 252, 122 N.Y.S.2d 312 (1st Dep't 1953), rev'd on other grounds, 305 N.Y. 13, 110 N.E.2d 402 (1953).

149. Supra note 146.

cases in New York apply the uniform rule that, in determining fair value for appraisal purposes, consideration must be given to "investment value" and "net asset" factors along with "market value"—although market value is probably the most influential factor where, as indicated above, the circumstances are propitious for its use.[150] In applying the "net asset" theory of value, courts view the corporation in its "going-concern" character rather than in terms of its dissolution. It is the value of the assets, used as a clue to price, by an intelligent investor seeking to purchase a minority interest in a going concern, which constitutes the basis for estimating value under this theory.[151] The "net asset" approach has received its greatest support in cases where there is no market for the shares in question, that is, in close corporation type cases.[152]

D. *Preemptive rights*

The shareholder's right to preserve his relative voting and dividend position in the corporation by preempting a pro-rata portion of new shares to be issued by the corporation, recognized at common law, was first codified, in 1941, in Section 39 of the New York Stock Corporation Law, the most comprehensive statutory treatment of the preemptive right in the country. The essential structure and substance of this statute has been retained, with but a minor addition, in *Section 622* of the Business Corporation Law. Although the provisions of the statute are made exclusive under *paragraph (i)* of Section 622, a brief review of the common law background will aid in illuminating some of the substantive features of the statute and in an understanding of residual problems. The earliest definitive recognition of the preemptive right in New York came in the landmark case of *Stokes v. Continental Trust Co.*[153] in which the Court of Appeals treated the preemptive right as an inviolable "vested right of property" which could be neither eliminated nor impaired without the affected shareholder's consent. The Court settled the theory of the preemptive right for New York in the following comment:

> . . . a stockholder has an inherent right to a proportionate share of new stock issued for money only and not to purchase property for the purposes of the corporation or to effect a consolidation, and while he can waive the right, he cannot be deprived of it without his consent except when the stock is issued at a fixed price not less than par, and he is given the right to take at that price in proportion to his holding, or in some other equitable way that will enable him to

150. In re Fulton, supra note 146; In re Marcus (R. H. Macy & Co.), supra note 147; In re Karlin (United Paramount Theatres), 202 Misc. 792, 111 N.Y.S.2d 96 (Sup. Ct. 1951); see generally, Note, 16 Brooklyn L. Rev. 86 (1949).

151. In re Fulton, supra note 146; Jones v. Healy, 184 Misc. 923, 55 N.Y.S.2d 349 (Sup. Ct. 1945), aff'd, 270 App. Div. 895, 62 N.Y.S.2d 605 (1st Dep't 1946), appeal denied, 296 N.Y. 1058 (1947); In re Behrens, supra note 147.

152. In re Marcus (R. H. Macy & Co.), 191 Misc. 808, 77 N.Y.S.2d 529 (Sup. Ct. 1948).

153. 186 N.Y. 285, 78 N.E. 1090 (1906).

protect his interest by acting on his own judgment and using his own resources.[154]

It will be noted that the right of the shareholder to maintain his ratio of control or equity in the corporation was held to exist where (a) new shares were to be issued; (b) for cash (and not for property or to effect a consolidation); and (c) at not less than the par value of the shares. The Court squarely upheld the right of the corporation to fix the price at which the preemptive right could be exercised at the fair value of the shares (considerably above par) and established as the measure of damages for breach of the preemptive right the difference between the market value of the shares on the day of the sale to the outsider (banking house) and the price at which the corporation had contracted to sell such shares to the bank. Shareholders are not relegated to a suit for damages in the event the preemptive right is violated. They can insist upon their right to a proportion of the shares, for "otherwise the majority could deprive the minority of their proportionate power in the election of directors and their proportionate right to share in the surplus . . . ."[154a]

The prevailing notion that the preemptive right did not exist with respect to *originally authorized but unissued shares* was reviewed and qualified by the Court of Appeals in *Dunlay v. Avenue M Garage & Repair Co.*[155] The Court suggested that the proposition that original issue is not subject to preemptive rights had been stated too broadly. It was true if originally authorized shares were issued for ordinary going-concern purposes to raise money to be used in the conduct of the business, but was not true if the original issue had been reserved, in the early corporate projection, for purposes of a possible future expansion of corporate activities. In the latter case, the shareholders would presumably not have established their ratio of ownership on the basis of the *total* original authorization. In addition, a preemptive right in original issue, although not available as a general rule, is generated when directors authorize the issue to themselves of originally authorized shares for the primary purpose of converting their status from minority to majority shareholders. "Such conduct," said the Court, ". . . is inequitable in the highest degree. It involves a breach of the duty of the directors as fiduciaries representing all the stockholders, irrespective of any doctrine of preemptive right . . . . Before acquiring stock for such a purpose, the directors should offer it a fixed price to all the stockholders, sell at auction, or obtain a waiver of their rights."[156] This equitable doctrine that a preemptive right may be created when directors breach their fiduciary duty to the shareholders by an improper use of original issue—was applied by the Appellate Division in *Hammer v. Werner*[157] where the shares taken by the directors to con-

154. Id. at 299, 78 N.E. at 1094-5.
154a. Id. at 298, 78 N.E. at 1094.
155. 253 N.Y. 274, 170 N.E. 917 (1930).
156. Id. at 279, 170 N.E. at 919.
157. 239 App. Div. 38, 265 N.Y. Supp. 172 (2d Dep't 1933).

vert themselves into majority shareholders were *treasury shares,* normally not subject to preemptive rights.

The foregoing common law authorities did not carefully delineate the character of the voting control and dividend rights to be protected by the exercise of the preemptive right. Should, for example, a non-voting preferred shareholder with no interest in the balance of the surplus remaining after his preference is paid be entitled to a pro-rata share of newly created shares of his own class or a new class of preferred or common shares, or should contingent voting shareholders be so entitled with respect to a new issue of shares of their own class or voting shares of a new class? This problem area is carefully manicured in *paragraph (a)* of Section 622 which defines with precision the kinds of shares that are entitled to exercise preemptive rights. These are: (a) voting shares, described as shares possessing an *uncontingent* right to vote for the election of one or more directors; and (b) "equity" shares with "unlimited dividend rights," described as shares possessing "the right without limitation as to amount either to all or to a share of the balance of current or liquidating dividends after payment of dividends on any shares entitled to a preference." So defined, equity shares would clearly include common shares and participating preferred shares, but would not include ordinary preferred shares which have no interest in the balance of current or liquidating dividends after their preferences are accounted for. *Under paragraphs (b) and (c)*, except where a contrary provision is made in the certificate of incorporation, such equity and voting shares are entitled to exercise the preemptive right as to subsequently issued *equity* shares, or shares or other securities convertible into or carrying rights or options to purchase such equity shares, and voting shares or shares or other securities convertible into or carrying rights or options to purchase voting shares, as the case may be. *No preemptive right is available with respect to newly issued (non-equity) preferred shares or contingent voting shares.*

At the outset of the revision project, it was suggested by the New York State Bar Association that "in failing to assign a priority as between preservation of relative voting rights and relative dividend rights, it (the present Section 39 of the New York Stock Corporation Law) imposes requirements which in practical situations prove unworkable."[158] The practical problem of effectively implementing the preemptive right when complex capital stock structures are involved has been noted by the commentators—indeed, one commentator has suggested preserving the preemptive right idea only for the protection of voting rights and leaving the protection of dividend and assets rights to judicial implementation on the basis of equitable principles.[159] A

158. See Joint Legislative Comm. to Study Revision of Corporation Laws, (First) Interim Report to 1957 Session of N.Y. State Legislature, N.Y. Legis. Doc. No. 17 (1957), at 84-85.

159. Frey, Shareholders' Preemptive Rights, 38 Yale L.J. 586, 583 (1929).

number of states deny the exercise of preemptive rights unless specifically prescribed by the certificate of incorporation. It has been suggested that the latter approach is preferable because it permits the corporation to design the preemptive right in a practical manner at the time each class of shares is authorized.[160] Such arguments aside, however, if the common law formulation of the preemptive right is to be retained as a matter of policy—as it is in Section 622—an entirely satisfactory solution of the question of priorities does not seem feasible as a matter of policy choices or drafting convenience. That is why *paragraph (d)* retains the general formulation of the existing statute that "In case each of the shares entitling the holders thereof to preemptive rights does not confer the same unlimited dividend right or voting right, the board shall apportion the shares or other securities . . . in such proportions as in the opinion of the board shall preserve *as far as practicable* the relative unlimited dividend rights and voting rights of the holders at the time of such offering. The apportionment made by the board shall, in the absence of fraud or bad faith, be binding upon all shareholders." (Emphasis added.) A solution of the problem of priorities as between voting and equity shares is available to some degree by the device of selecting new securities that skirt the preemptive right altogether, or by the creation, where feasible, of new classes of shares perfectly parallel in all respects with existing classes. In addition, by making the preemptive right subject to any contrary provision of the certificate of incorporation, Section 622 authorizes the limitation or total elimination of preemptive rights in newly organized corporations. In the case of existing corporations, the preemptive right may be excluded altogether or limited by depriving a class of existing preemptive rights or of a preemptive right in a newly created class by amendment of the certificate of incorporation under *Section 801*, subject, however, to the right of appraisal available under *subparagraph (b) (6) (C) of Section 806* to shareholders adversely affected thereby.[161]

As indicated above, preemptive rights were made available at common law only when new shares were to be issued for cash. In codifying the common law exceptions to the preemptive right *paragraph (e)* retains, with a minor addition, existing statutory provisions. Thus, no preemptive rights are available when new shares are issued for: (1) merger or consolidation purposes;[162] (2) consideration other than cash (this includes, but is not limited to, the purchase of property and the payment of debts);[163] (3) the satisfac-

160. Drinker, The Preemptive Rights of Shareholders to Subscribe to New Shares, 43 Harv. L. Rev. 586, 614 (1930).

161. This could not be accomplished prior to the 1943 amendment of N.Y. Stock Corp. Law § 35 authorizing the alteration or abolition of preemptive rights (see Stokes v. Continental Trust Co., supra note 153; Albrecht, Maguire & Co. v. General Plastics, Inc., 256 App. Div. 134, 9 N.Y.S.2d 415 (4th Dep't 1939), aff'd, 280 N.Y. 840, 21 N.E. 887 (1939)).

162. Supra note 153 at 299, 78 N.E. at 1094, 1095.

163. Id. at 298, 299, 78 N.E. at 1094. See also Musson v. New York & Queens El.

tion of outstanding conversion and option rights;[164] (4) purposes of reorganization under any applicable Act of Congress and (5) the satisfaction of option rights under paragraph (4) of Section 505—*a new exception.* In addition, no preemptive rights may be exercised under paragraph (e) when (6) treasury shares[165] are issued by the corporation, or where (7) originally authorized shares are issued within two years after filing the certificate of incorporation. This latter provision (incorporated into Section 39 of the New York Stock Corporation Law in 1941 and perpetuated in the new Law) codifies *Dunlay v. Avenue M Garage & Repair Co.*[166] to the degree that originally authorized shares, retained by the corporation beyond the two-year period after the filing of the certificate of incorporation are made subject to preemptive rights (*in a sense,* it may be said that a conclusive statutory presumption is created that such shares were intended to be reserved for future expansion purposes). Since, under *paragraph* (*i*), the statutory provisions affecting preemptive rights are exclusive, this aspect of the *Dunlay* case (decided prior to the effective date of the statute) is surely subordinated to the statutory provision. Quaere, as to the extent to which the statute affects the other aspect of the *Dunlay* case that directors cannot utilize original issue (not otherwise subject to preemptive rights) to convert themselves into majority shareholders, and that shares so improperly utilized would be subject to the prior rights of the shareholders? Presumably, the legislature did not purport to affect the equitable powers of the court to control derelictions by faithless fiduciaries.[167] Nor has the legislature found it feasible to deal legislatively with the problem that arises when directors (or majority shareholders), in breach of their fiduciary duty, seek to dilute the minority shareholders' preemptive rights (and consequent equity in the corporation) by making a new offering of securities which the directors know the minority shareholders are not in position to take up. Although an early appellate court in *Schramme v. Cowin*[168] refused to provide relief in such a case on the grounds that there had been no adequate showing of bad faith and that, in any event, the minority shareholder was entitled to sell his "rights," in the recent case of

& P. Co., 138 Misc. 881, 247 N.Y. Supp. 406 (Sup. Ct. 1931) holding that no preemptive right exists when shares are to be issued in payment of a corporate debt.

164. Venner v. American Telegraph & Telephone Co., 110 Misc. 118, 181 N.Y. Supp. 45 (Sup. Ct. 1920), aff'd, 196 App. Div. 960, 188 N.Y. Supp. 856 (1st Dep't 1921); Hackett v. Northern Pacific R. Co., 36 Misc. 583, 78 N.Y. Supp. 1087 (Sup. Ct. 1901).

165. Hammer v. Werner, supra note 157; Gillette v. Noyes, 92 App. Div. 313, 86 N.Y. Supp. 1062 (1st Dep't 1904); Borg v. International Paper Co., 11 F.2d 147 (2d Cir. 1925) stated this to be the common law rule.

166. Supra note 155.

167. See also Hammer v. Werner, supra note 157, in which the court recognized that treasury shares which the corporation had not retired nor held in the treasury for an inordinately long time were not subject to preemptive rights upon issuance, but held, in the particular circumstances, on the authority of the Dunlay case, that a preemptive right did exist with respect to treasury shares sold by the directors to themselves in breach of their fiduciary obligations to the minority shareholders. See also on this point, Sorin v. Shahmoon Industries, Inc., supra note 53 at 416, 417, 220 N.Y.S.2d at 772.

168. 205 App. Div. 20, 199 N.Y. Supp. 98 (1st Dep't 1923).

Tashman v. Tashman,[169] a lower court, citing the *Dunlay* case, enjoined the new stock issue and held that the minority shareholder was entitled to a trial of his allegation that the shares were issued solely for "the sinister purpose of serving the personal ends of the directors."[170]

E. *Right of Inspection*

The development and rapid expansion of the publicly-held corporation, characterized by the increasing separation of corporate ownership from corporate control, has transformed the shareholder's common law right to inspect the general books and records of the corporation into a vital expedient for safeguarding his investment in the corporation. The right to inspect the general books and records, currently found in Section 10 of the New York Stock Corporation Law, is perpetuated in *Section 624* of the Business Corporation Law. As far back as 1899, the Court of Appeals, in *In re Steinway*,[171] declared that the statute had not preempted the common law right of inspection. This rule is reinforced by the express provision in *paragraph (f)* of Section 624 that nothing contained in the statute shall impair the power of the courts to compel the production for examination of the books and records of the corporation. (It should be observed carefully that the reference in paragraph (f) to "books and records" cannot be construed to include the "minutes of the proceedings of the shareholders" or the "record of shareholders," both of which are delineated and treated separately from "books and records" throughout Section 624).

The common law remedy for compelling the production of the corporate books and records for examination was the writ of mandamus, which has been replaced by the current proceeding under Article 78 of the New York Civil Practice Act. The availability of the remedy, at common law and presently under Article 78, rests in the sound discretion of the court, and will normally be granted only when the inspection is sought, in good faith, for a proper purpose that is germane to the status of the shareholder. In recent cases the right of inspection has been granted for such purposes as: seeking shareholders to intervene in a pending derivative suit to avoid the need to post a bond as security for the corporation's expenses in the suit[172] (although an inspection was denied in another recent case[173] where sought for the purpose of discovering a "contemporaneous owner" to *initiate* a derivative suit); to induce shareholders to approve a merger with one company rather than a proposed merger with another;[174] to persuade the shareholders,

169. 13 Misc. 2d 982, 984, 174 N.Y.S.2d 482, 483 (Sup. Ct. 1958).
170. See for discussions of this subject, Note, Judicial Control Over the Fairness of the Issue Price of New Stock, 71 Harv. L. Rev. 1133 (1958); Blais, Shareholder Protection From Share Watering Caused by Additional Issue of Stock, 19 Fac. of L. Rev. (U. of Toronto) 43 (1961).
171. 159 N.Y. 250, 53 N.E. 1103 (1899).
172. Ratzkin v. Harris, 219 N.Y.S.2d 665 (Sup. Ct. 1961).
173. In re Levy, 138 N.Y.L.J. 9, Col. 7 (Sup. Ct. Kings County) Oct. 30, 1957.
174. In re Huber, 26 Misc. 2d 563, 210 N.Y.S.2d 211 (Sup. Ct. 1960).

by proxy solicitation and otherwise, to oust incumbent directors and to substitute a slate approved by the shareholder seeking the inspection;[175] to verify the basis for the amounts set forth in the corporation's annual report.[176] Inspection has traditionally been made available, in propitious circumstances, for the purpose of evaluating a petitioner's shareholdings in the corporation.[177] Contrariwise, inspection has been denied where sought for such improper purposes as: blackmail; to satisfy idle curiosity; speculation; sale of shareholder lists; aid in personal litigation unrelated to the corporation; and, generally, for purposes inimical to the interests of the corporation and its shareholders. In recent cases, inspection was denied where sought solely for the purpose of aiding the petitioner-executor to prepare federal and state tax returns.[178]

The burden of proof on the issue of whether the shareholder-petitioner is seeking the right of inspection in good faith and for a proper purpose is imposed in the recent cases upon the respondent corporation,[179] although the rule is not free from ambiguity. The cases appear to impose upon the petitioner-shareholder the obligation of alleging in his petition, in the first instance, the *particular* purpose for which he seeks an inspection. Presumably, although he must *plead* such precise purpose, he does not have the burden of *proving* it—the burden being cast upon the respondent corporation of *disproving* the petitioner's allegation. The apparent reason for requiring petitioner to set forth facts establishing a proper purpose is to fix a frame of reference against which petitioner's bad faith can be put in issue and tested. In a recent case, affirmed without opinion in the Appellate Division, First Department, *In re Stoopack v. George A. Fuller Company*,[180] the lower court stated that the "petitioner is not required to show a specific purpose for the desired inspection and that the inspection is necessary for the protection of his interests and those of stockholders." This holding would appear to be at variance with the general rule.

Although the shareholder's common law right to an inspection normally depends on legal ownership of the shares, *paragraph (b)* codifies a recent holding without opinion in the Court of Appeals, *In re Zolta Baczkowska v. 2166 Operating Corp.*,[181] by expressly providing that voting trust certificate

175. Murchison v. Alleghany Corporation, 27 Misc. 2d 290, 210 N.Y.S.2d 153 (Sup. Ct. 1960).
176. Stoopak v. George A. Fuller Co., 18 Misc. 2d 977, 979, 190 N.Y.S.2d 596, 598 (Sup. Ct. 1959), aff'd, 9 A.D.2d 605, 191 N.Y.S.2d 356 (1st Dep't 1959).
177. Lewis v. Nat Lewis Retail Corp., 194 Misc. 427, 86 N.Y.S.2d 823 (Sup. Ct. 1949); In re Wygant, 101 Misc. 509, 167 N.Y. Supp. 369 (Sup. Ct. 1917).
178. Bankers Trust Co. v. H. Rosenhirch Co., 20 Misc. 2d 792, 190 N.Y.S.2d 957 (Sup. Ct. 1959); Application of Pearson, 223 N.Y.S.2d 15 (Sup. Ct. 1961).
179. See Durr v. Paragon Trading Corp., 270 N.Y. 464, 469, 1 N.E.2d 967, 969 (1936); Tate v. Sonotone Corp., 272 App. Div. 103, 105, 69 N.Y. Supp. 535, 536 (1st Dep't 1947); In re Hausner v. Hopewell Products, Inc., 10 A.D.2d 876, 201 N.Y.S.2d 252 (2d Dep't 1960).
180. Supra note 176.
181. 279 App. Div. 775, 109 N.Y.S.2d 348 (1st Dep't 1952), aff'd, 304 N.Y. 811,

holders shall be regarded as shareholders for all purposes of Section 624. *Record* ownership is not indispensable to an inspection of the general books and records, although, under paragraph (b), it may be required for an inspection of the "minutes of the proceedings of shareholder" and the "record of shareholders."[182] Of course, shareholder status must exist in order to qualify the petitioner for the inspection. Where petitioner is shown to have sold his shares to the corporation (although he remains registered on the books),[183] or where petitioner has accepted payment of a liquidating dividend and subsequently executed and filed a certificate of voluntary dissolution,[184] his status as a shareholder is lost and the right to an inspection will be denied. No such consequence follows from a mere pledge of corporated shares.[185] Petitioner's status as a shareholder is normally tested by a reference,[186] although it has been suggested that the determination of status can be made on papers alone.[187] A lower court recently held that, for the purpose of determining the right of an inspection, title to shares will not be tested in a plenary proceeding to litigate ownership rights under a contract. Presumably, only *present* status will be passed on for such purpose.[188]

Section 624 is primarily concerned with the "minutes of the proceedings of the shareholders" and the "record of shareholders" (commonly referred to as the "stock book"). These corporate records are delineated from the general books and records in two essentials: first, under paragraph (b), such records may be inspected in person or by agent or attorney during usual business hours[189] only by shareholders *of record* for at least six months immediately prior to the demand, or by any person who holds (or is authorized in writing to inspect by holders of) at least five percent of all outstanding shares (as contrasted with an inspection of the general books and records available to *any* shareholder).[190] In implementing a parallel provision in Section 10 of the New York Stock Corporation Law the courts have hewed very closely to

109 N.E.2d 470 (1952). But cf., Brentmore Estates v. Hotel Barbizon, 263 App. Div. 389, 33 N.Y.S.2d 331 (1st Dep't 1942).

182. Neisloss v. Alleghany Corp., 141 N.Y.S.2d 732 (Sup. Ct. 1955); see also Joannou v. Joannou Cycle Co., 6 A.D.2d 592, 180 N.Y.S.2d 141 (1st Dep't 1958).

183. Rosenberg v. Steinberg-Kass, Inc., 6 A.D.2d 685, 174 N.Y.S.2d 87 (1st Dep't 1958); Schor v. Barshor Realty Co., 218 N.Y.S.2d 11 (Sup. Ct. 1961). But cf., Nash v. Gay Apparel Corp., 8 N.Y.2d 978, 204 N.Y.S.2d 545 (1960), affirming 9 A.D.2d 345, 193 N.Y.S.2d 246 (1st Dep't 1959), reversing 16 Misc. 2d 176, 187 N.Y.S.2d 32 (Sup. Ct. 1959).

184. Schor v. Barshor Realty Co., supra note 183.

185. Carthage Paper Makers v. Mutual Box Board Co., 2 A.D.2d 175, 153 N.Y.S.2d 759 (4th Dep't 1956).

186. See N.Y. Civ. Prac. Act § 1295.

187. Joannou v. Joannou Cycle Co., supra note 182; Engelhardt v. Hertlein Special Tool Co., 157 N.Y.S.2d 529 (Sup. Ct. 1956).

188. Engelhardt v. Hertlein Special Tool Co., supra note 187.

189. This changes the existing statute which allows the corporation to limit the inspection period to three hours daily.

190. It will be noted that the existing statute is changed by eliminating judgment creditors from the category of persons entitled to inspect the stock book and the minutes of the meetings of shareholders. The revisers' notes to Section 624 states that creditors "should be able to obtain inspection pursuant to a court order in pending litigation."

the requirement that the shareholder seeking to inspect the stock book be registered;[191] and, second, under *paragraph* (*c*) the right to inspect these records is qualified, as it is under the existing statute, to the extent that it may be denied to a person who refuses to furnish an affidavit that the inspection is not desired for a purpose alien to that of the corporation and that he has not engaged, within a period of five years prior to the demand, in the business of selling "stock lists" of any corporation.

In granting a *summary* remedy in the Supreme Court for the enforcement of the right to inspect the shareholder minutes and stockbook, *paragraph* (*d*) departs radically from the sanction imposed by the present statute—a penalty in the form of money damages against the corporation and the officers responsible for an improper denial of the right of inspection. The elimination of the penalty and the creation of a new statutory remedy would seem clearly designed to resolve the problem that has arisen, in implementing the present statute, as to the "absolute" or "discretionary" character of the right to inspect the stock book. On its face, this right would appear to be granted absolutely, subject, however, to the two built-in exceptions that it not be sought for a purpose foreign to that of the corporation (a very broad exception that is almost co-terminous with the common law "improper purpose" exception) and that it is not sought by a shareholder who is in the business of selling stock lists. It would seem that a court, in a mandamus proceeding, would have no discretion to deny such an inspection, short of satisfying itself that either of the interdicted acts have occurred. So the Court of Appeals has held in a dictum in *In re Steinway*[192] and squarely in *Henry v. Babcock & Wilcox.*[193] Intermediate appellate courts have likewise viewed the right as an absolute one.[194] The Appellate Division, First Department, has taken a consistently contrary view on the premise that in a proceeding under Article 78 of the Civil Practice Act, since a purely discretionary remedy is invoked by the petitioner, the court has an unregulated discretion to withhold the inspection upon a finding that the purpose for which it is sought is *in any respect* improper and may investigate such purposes generally, unrestricted by the particular exceptions embodied in the statute.[195] It has been suggested that the view taken by the Appellate Division, First Department, is consistent with

191. See cases cited supra, note 182.

192. Supra note 171.

193. 196 N.Y. 302, 89 N.E. 942 (1909). See also in this context, Cotheal v. Brower, 5 N.Y. 562 (1851).

194. In re Hurley v. National Bank of Middletown, 252 App. Div. 272, 299 N.Y. Supp. 241 (2d Dep't 1937); People ex rel. Callanan v. Keeseville, A.C. & L.C.R. Co., 106 App. Div. 349, 94 N.Y. Supp. 555 (3d Dep't 1905); People ex rel. Clason v. Nassau Ferry Co., 86 Hun 128, 33 N.Y. Supp. 244 (1st Dep't 1895).

195. Tate v. Sonotone Corp., 272 App. Div. 103, 69 N.Y.S.2d 535 (1st Dept 1947). The majority view taken by the court in this case was subjected to a very sharp dissent by the late Justice Cohn. The Tate case has recently been cited with apparent approval by the Court of Appeals in Breswick & Co. v. Greater New York Industries, Inc., 308 N.Y. 1041, 127 N.E.2d 871 (1955), but on the issue of good faith in a proceeding seeking an inspection of the general books of the corporation.

the legislative intention to make the right to inspect the stock book absolute only to the extent of the penalty provided for its improper denial, but that the legislature did not intend to fetter the recognized discretion of the Supreme Court in an Article 78 proceeding.[196] While it is true that in the cases in which the Court of Appeals has squarely held the right to be absolute the remedy sought was the statutory penalty and not an inspection, in *In re Steinway*,[197] which involved a mandamus proceeding to compel an inspection, the Court was moved to make the following pertinent comment: "The statute merely strengthened the common law rule with reference to one part thereof, and left the remainder unaffected. *It dealt with but a single book, and as to that it amplified the qualified right previously existing, by making it absolute and extending it to judgment creditors*."[198] (Emphasis added.) This language would appear clear beyond peradventure. The history of the inspection statute serves to justify the conclusion that the legislature intended the right to be an absolute one. Both the *Steinway* and the *Henry* cases were decided under the old Section 29 (laws of 1890), the predecessor of the current statute, which provided merely that the stock book (which had been treated specially by statute since 1818) should be available for inspection during three business hours daily. In 1916, the statute was amended to include, *for the first time*, the foregoing exceptions to the right to inspect the stock book. It would seem a reasonable inference, the decisions in *Steinway* and *Henry* presumably known to it, that the legislature intended to subject the previous absolute right to the qualifications imposed under the 1916 amendment—but only to these. There are surely good reasons for treating the stock book differently from the general books and records. As the Court pointed out in the *Steinway* case, "the stock book has no relation to the business carried on by a corporation; and the change was doubtless made to enable stockholders to promptly learn who are entitled to vote for directors . . . ."[199] The ready availability of the stock book to afford shareholders quick access to fellow shareholders is a highly desirable facet of corporate democracy. In any event, the change wrought by Section 624 in eliminating the statutory penalty and substituting a new statutory *judicial* remedy for the enforcement of the right to inspect the shareholder minutes and stock book *displaces the Article 78 (mandamus) remedy*—for the rule is clear that mandamus will not lie where another remedy is available or provided by law. After the effective date of the new law, a shareholder denied the right to inspect the shareholder minutes or stock book will seek to enforce his right under the special remedy provided in paragraph (d) of Section 624. It would no longer seem possible in such a proceeding for

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196. See People ex rel. Britton v. American Press Ass'n, 148 App. Div. 651, 133 N.Y. Supp. 216 (1st Dep't 1912). See also Henn, Corporations 327 (1961).
197. Supra note 171.
198. Id. at 263, 53 N.E. at 1107.
199. Id. at 264, 53 N.E. at 1107.

the court to investigate the petitioner's purposes generally—the sole qualifications on the right being set forth in paragraph (c).

Paragraph (e), the counterpart of Section 77 of the New York Stock Corporation Law, gives any shareholder who requests it in writing the right to the most recent balance sheet and profit and loss statement which have been distributed to the shareholders or otherwise made public. An amendment to paragraph (e) recommended for adoption at the 1962 session of the New York State Legislature[199a] would change this provision by giving the right to such financial statements, as in paragraph (b), to shareholders of record for at least six months immediately preceeding the demand or to any person holding (or authorized in writing by the holders of) at least five percent of all outstanding shares. In any event, the new law does not alter in any significant substantive way the right to the financial statements of a corporation that is afforded under existing law. A more dimensional review of the financial situation of the corporation is, of course, available via the inspection route previously discussed.

Section 1315, the counterpart of Section 113 of the New York Stock Corporation Law, fashions a separate remedy in behalf of residents of the state to inspect the "record of shareholders" of a foreign corporation doing business in this state. It is to be noted that the section is restricted in its provisions to the stock book only (it does not make any express provision for the general books and records, or the minutes of meetings of shareholders, board and executive committee, or for the right to financial statements as does Section 624). It is otherwise the precise counterpart of Section 624.

II. *Subscriber and shareholder liability*

It is axiomatic that shareholder immunity from liability for the debts and obligations of the corporate entity—the "limited liability" concept—is the keystone of the corporate system. When shares are issued by a corporation as "fully paid and nonassessable," the shareholder is normally secured against liability for further losses incurred in the conduct of the business beyond his original investment. Under the New York common law rule, a corporation that had contracted to issue par value shares for less than their par value (either in cash or property), as fully paid and non-assessable shares, was bound by its contract and entitled legally only to the consideration for which the shares were contracted to be issued.[200] The fact that the statutory admonition that "no shares of stock having par value shall be issued for money in an amount less than the par value of such shares" had been violated did not affect the rule. Nor did a trustee in bankruptcy, receiver, or creditor of the corporation have better rights, under the common law rule, than the cor-

199a. This amendment was approved by the New York Legislature.
200. Southworth v. Morgan, 205 N.Y. 293, 98 N.E. 490 (1912); Christenson v. Eno, 106 N.Y. 97, 12 N.E. 648 (1887).

poration itself to recover from the subscriber the difference between his subscription price and the par value of the shares.[201] Of course, the subscriber would be liable to the corporation or anyone suing in its right for any unpaid portion of the consideration actually contracted to be paid for the shares—a subscription to shares of a corporation creating a debt enforceable by the corporation or persons legally capable of representing it.[202]

The common law rule was modified in New York by Section 70 of the New York Stock Corporation Law which imposes liability upon shareholders, in the prescribed circumstances, in favor of corporate *creditors*. The common law rule remains unaffected by this section insofar as the corporation or anyone acting in its behalf is concerned. The statute makes every *holder of shares* "not fully paid" personally liable to creditors of the corporation in an amount equal to the amount unpaid on the shares held by him. Only those shareholders are charged with liability who held the shares at the time the debt (to plaintiff-creditor) was incurred. Accordingly, it has been held that a transfer of shares prior to the time the debt was incurred will exonerate the transferor from any liability under Section 70 to corporate creditors.[203] Although the statute in terms makes every "holder" of shares liable to creditors, some conflict is reflected in the cases on the question of whether a subsequent bona fide transferee of shares without notice that they were not fully paid is chargeable under the statute if he is the "holder" of such shares when the debt is incurred.[204] While it would seem quite clear that Section 70 is designed to impose liability on holders of "watered," "discount" or "bonus" shares, and is not aimed at the subscriber who has contracted to pay full par value for his shares on installment or subject to call but has failed to meet the installment payments or to honor the calls (since in such case, the subscriber is in any event exposed to common law liability to the corporation, or its legal representative, for the whole or any part of the unpaid consideration), evidence is available in the cases that the latter type of subscriber is likewise within the ambit of the statute and would be chargeable thereunder *to the individual creditor*.[205] Section 70 is thoroughly qualified by Section 73 of the New York Stock Corporation Law. Under this section, only *judgment* creditors with

201. Christenson v. Eno, supra note 200.
202. Stoddard v. Lum, 159 N.Y. 265, 53 N.E. 1108 (1899).
203. Tucker v. Gillman, 121 N.Y. 189, 24 N.E. 302 (1890).
204. Compare Breck v. Brewster, 150 App. Div. 202, 134 N.Y. Supp. 697 (1st Dep't 1912); by way of analogy, Briggs v. Waldron, 83 N.Y. 582 (1880) which held, under an early statute making subscribers responsible for debts of the corporation, until the entire subscription price was paid in, that a transferee of the shares was chargeable—with Van Slochem v. Villard, 154 App. Div. 161, 138 N.Y. Supp. 582 (1st Dep't 1912), aff'd (without discussion of this point), 207 N.Y. 587, 101 N.E. 467 (1913). Note, White v. Jones, 167 N.Y. 158, 60 N.E. 422 (1901) which suggested in a dictum that perhaps a transferee could not be charged.
205. See Business Advisory Bureau v. Stallforth, 262 App. Div. 162, 28 N.Y.S.2d 437 (1st Dep't 1941), aff'd, 289 N.Y. 792, 47 N.E.2d 48 (1943); Granger & Co. v. Allen, 214 App. Div. 367, 212 N.Y. Supp. 356 (4th Dep't 1925), aff'd sub. nom., Empire Produce Co. v. Allen, 244 N.Y. 587, 155 N.E. 907 (1927).

execution against corporate assets returned unsatisfied may seek the benefits of Section 70—and even such creditors must have originally owned contract claims[206] which were to mature within two years from the time they were contracted (ruling out, for the most part, bondholders and mortgage noteholders). Furthermore, the statute provides that suit on the judgment must be brought within two years after the shareholder sought to be charged has ceased to be one (a shareholder ceases to be one for the purposes of this section after he has transferred his shares, or after the dissolution, or adjudication of bankruptcy of the corporation).[207] To further complicate the remedy, the Court of Appeals in *Bottlers Seal Company v. Rainey*[208] held that enforceability of rights under Sections 70 and 73 is possible only through a suit in equity on behalf of all creditors entitled to the remedy against all shareholders liable under the statute, who are within the state and solvent.

The problem of watered, discount and bonus shares has, as a practical matter, diminished in importance with the advent of no-par value shares (introduced in New York—the first state to adopt this financing mechanism—in 1912), the increased use, in capitalizing corporations, of low par shares, and the disclosure requirements of the Securities Act of 1933. These factors account for the radical departure from existing law reflected in *Section 628* of the Business Corporation Law.

(a) *Paragraph (a)* of Section 628 provides that a subscriber shall be under no obligation to the corporation other than to pay the unpaid portion of his subscription price, subject, however, to the qualification that the subscription price "shall in no event be less than the amount of the consideration for which (such) shares could be issued lawfully." This latter qualification overrules the common law doctrine of *Christenson v. Eno*[209] and *Southworth v. Morgan*,[210] alluded to above, which precluded the corporation from recovering the balance of the consideration that should have lawfully been paid upon the subscription for shares. Hence, under the new law, were the corporation to issue shares, in violation of *Section 504*, for inadequate consideration, recovery of the full lawful consideration would now be possible *by the corporation* (or presumably by any person legally capable of representing it). It is to be noted very carefully that the remedy is now given to the corporation exclusively. *The creditor no longer has a remedy in his individual right* (and hence Sections 70 and 73 of the New York Stock Corporation Law have been entirely superseded). In a suit under paragraph (a), any recovery by

206. See Assets Realization Co. v. Howard, 70 Misc. 651, 127 N.Y. Supp. 798 (Sup. Ct. 1911), aff'd, 152 App. Div. 900, 136 N.Y. Supp. 1130 (4th Dep't 1912), aff'd, 211 N.Y. 430, 105 N.E. 680 (1914).

207. See Lang v. Lutz, 180 N.Y. 254, 73 N.E. 24 (1905); Business Advisory Bureau v. Stallforth, supra note 205; Granger & Co. v. Allen, supra note 205.

208. 243 N.Y. 33, 153 N.E. 437 (1926).

209. Supra note 200.

210. Supra note 200.

the corporation, or its representative, becomes a corporate fund for the benefit of shareholders as well as creditors.

(b) Under *paragraph (b)*, a bona fide transferee of shares or a subscription for shares without knowledge that full consideration has not been paid is not liable for the unpaid portion of such consideration; the transferor remains liable. This provision, fashioned after Section 23 of the Model Act, rejects the view that the share is "tainted" by a violation of Section 504 and imposes liability upon the original subscriber only.[211] To the extent, however, that a subsequent transferee has knowledge of the impropriety of the original issue, the shares are tainted in his hands and he is likewise assessable. The formulation under the new law thus avoids the ambiguity engendered by the existing statute which imposes liability upon the "holder" (as contrasted with the "subscriber") of shares.

(c) *Paragraph (c)* continues in almost their precise terms the provisions of Section 72 of the New York Stock Corporation Law. In sum, it provides that the pledgor of shares, and not the pledgee, shall be liable for any unpaid consideration under paragraph (a), and that no person holding shares as a fiduciary shall be personally liable, but the estate and funds controlled by such fiduciary shall be liable under the Section.

Section 629 of the Business Corporation Law represents the shell that has remained after the evisceration of Section 15 of the New York Stock Corporation Law—New York's current "little bankruptcy Act."[212] Under the latter section, a transfer of shares made in contemplation of the insolvency of the corporation is void. Under Section 629, the transfer is not void but the transferor cannot thereby escape liability for any unpaid consideration under paragraph (a) of Section 628. This section seems altogether superfluous since the effect achieved by it would result in any case from a proper application of the provisions of paragraphs (a) and (b) of Section 628.

The limited-liability principle is subject to what might be aptly described as a "notorious" exception—the now celebrated Section 71 of the New York Stock Corporation Law, which provides the sole basis for exposing a shareholder of a New York corporation (it has been held inapplicable to foreign corporations)[213] to liability beyond his original risk capital. This section, dating back to 1848, had evoked little comment until it came into sharp focus in 1952 when the holder of a single $10 nonvoting share in the New York Compass was sued for "fringe" benefits in the amount of $130,000 by the employees of the bankrupt newspaper. The suit was brought under the fore-

211. This paragraph of Section 628 is not likely to be invoked often since, under paragraph (g) of Section 504, no certificate representing partly-paid shares may be issued —as is currently possible under N.Y. Stock Corp. Law § 74.

212. Section 15 of the N.Y. Stock Corp. Law was eliminated under great pressure from the organized bar, which argued that ample remedies for corporate creditors were provided by the federal bankruptcy act, the New York debtor-creditor law and other federal and state laws.

213. Armstrong v. Dyer, 268 N.Y. 671, 198 N.E. 551 (1935).

going statute which provides that laborers, servants or employees (construed by the courts to include all non-executive corporate personnel)[214] may charge the shareholders *jointly or severally* for unpaid debts, wages or salaries. By an amendment in 1952, wages and salaries were defined to include every variety of fringe benefits, including vacation, holiday and severance pay, and contributions to pension or annuity funds.[215] The vice inherent in the statute lies in its imposition of "several" liability—so that *any* shareholder, however small his holdings in the corporation, may be personally liable for the full judgment (which may be extremely large in view of the extended definition of wages and salaries). Moreover, *case law does not clarify the contribution rights of the shareholder who has paid the entire judgment.* May he hold only those shareholders who have been notified, as provided by the statute, that they are chargeable with payment of the unpaid wages and salaries, or would any shareholder be required to contribute? In what amount may other shareholders be charged? To what extent would the equitable doctrine requiring joinder of all shareholders similarly liable (so as to work an equitable apportionment of responsibility) be applicable?[216] Would contribution suits be entertained in foreign jurisdictions against important shareholders residing outside of New York and not amenable to suit here?[217]

Comments in legal periodicals[218] and statements by the organized bar[219] have called for the elimination of Section 71 as constituting a trap for the unwary investor, and as inconsistent with the fundamental character of the corporation as a business instrumentality designed to protect the investor from the possibility of financial risk beyond his original investment. In testifying at public hearings, spokesmen for labor tacitly conceded that Section 71 has rarely been invoked against shareholders of publicly-held corporations and that perhaps it was unduly indiscriminate in its uniform application to all

214. See Bristor v. Smith, 158 N.Y. 157, 53 N.E. 42 (1899); Hill v. Spencer, 61 N.Y. 274 (1874). These cases may have to be re-evaluated, however, in light of the 1952 amendment to N.Y. Stock Corp. Law § 71.

215. Note the recent case of Greenberg v. Corwin, 222 N.Y.S.2d 80 (Sup. Ct. 1961) in which the court sustained a suit brought by the union (on behalf of its employee-members) under Section 71 to recover from the shareholders on a judgment which it (the union) had procured against the corporation for contributions to the health and welfare and retirement benefits funds, and for wages.

216. See Horowitz v. Winter, 129 Misc. 814, 222 N.Y. Supp. 233 (Munic. Ct. 1927) in which the court held that the doctrine of Bottlers Seal Co. v. Rainey, supra note 208 had no application to a suit under Section 71.

217. See Marshall v. Sherman, 148 N.Y. 9, 42 N.E. 419 (1895) where a corporate "double-liability assessment" statute of a sister-state was refused enforcement in New York because it created rights uniquely adapted to enforcement in the equity courts of the home state.

218. See Rogers and McManus, Stockholders' Booby-Trap: Partnership Liabilities of Stockholders under Section 71, New York Stock Corporation Law, 28 N.Y.U.L. Rev. 1149 (1953); Brownell, The Not-So-Limited Liability of Stockholders of New York Corporations, 27 N.Y.S. Bar. Bull. 58 (1955).

219. See Joint Legislative Comm. to Study Revision of Corporation Laws (First) Interim Report to 1957 Session of N.Y. State Legislature, N.Y. Legis. Doc. No. 17 (1957), at 79, 82, 96.

shareholders, but urged its retention, particularly in respect of the "chartered partnership" type of enterprise, on the ground of its social utility and beneficial effect generally upon the economic well-being of the community.

Section 630 of the Business Corporation Law represents an attempted compromise of the foregoing viewpoints. It retains the essential unlimited-liability character of Section 71 but mitigates some of its harsher aspects.

(a) *Paragraph (a)* restricts liability under the section to the *ten largest shareholders* as determined by their beneficial interest in the corporation as of the date when the services referred to in the section are performed. This change is patently of little moment for shareholders in the typical family-type (or very) close corporation, but there are a substantial number of medium-sized non-public issue corporations whose shareholders will be benefited.

(b) Paragraph (a) further confines the impact of Section 630 to corporations "the shares of which are not traded on a national securities exchange or regularly traded in an over-the-counter market by one or more members of a national or an affiliated securities association."[220] This provision eliminates one of the serious drawbacks to the incorporation of large enterprises in New York, of which the organized bar has consistently complained.

(c) In paragraph (a), time sequences for enforcing rights under the section have been adjusted in favor of unpaid employees. The time for the written notice, which must be given by the employee to the shareholders he intends to charge, has been extended from thirty days (the current period under Section 71) to ninety days after the termination of the employee's services. However, if, within such ninety-day period, the employee demands an examination of the record of shareholders under paragraph (b) of Section 624, notice must be given within sixty days after an opportunity to make such an examination has been afforded. The time within which to enforce the shareholders' liability has likewise been extended from thirty days (the current period under Section 71) to ninety days after return of an execution unsatisfied against the corporation upon a judgment recovered against it for unpaid wages or salaries.

(d) *Paragraph (c)* makes the right to contribution explicit by entitling any shareholder who has paid more than his pro-rata share of liability (as determined by his beneficial interest in the corporation) to contribution pro rata from the other shareholders *liable under the section* to the extent of any excess paid. Suit for such contribution may be brought jointly or severally. It will be noted that the foregoing provisions of paragraph (c) resolve some of the existing contribution problems discussed above. It is now clear that a maximum of ten (largest) shareholders, if so many exist, can be charged with

220. Note the similar formula embodied in N.Y. Bus. Corp. Law § 620(c) dealing with shareholder arrangements to "sterilize" the board of directors.

liability (although it is not clear whether those shareholders (of the ten) who have not been notified that they are to be charged, as provided in paragraph (a), are "liable under the section"). The liability of the shareholder for contribution will be measured by his pro-rata beneficial interest in the corporation, and an individual action for contribution may be brought against such a shareholder to reach his "several" liability. This would indicate that the equitable principle of mandatory joinder in contribution suits will not apply in the enforcement of contribution rights under this section.

The Status of Directors

A prefatory statement concerning the underlying approach to directors (and officers) adopted in the new law might not be amiss. A fine balance was sought between the need for maximum flexibility in corporate operation and for maximum protection of the shareholders' investment in the enterprise. Perhaps the most basic characteristic of the modern publicly-held enterprise—the separation of corporate ownership from corporate control—was kept in clear perspective at all times. The proxy device has, after all, drastically altered the essential character of the modern corporation. Yet, the realities of modern corporate life could not ultimately be denied, and the conclusion was inevitable that the "town meeting" conception of corporate democracy had to give way in some measure to the need for flexible and expeditious operation—with a consequent vesting in the corporate managers of larger areas of unregulated power. The over-all design of the new law as it affects the status of directors (and officers) assumes the fundamental integrity of the ordinary director—in whose honesty and competence the public has placed its trust and confidence. Newspaper headlines occasionally reveal that the trust has been misplaced. For this reason, the new law provides in the more sensitive areas, such as indemnification and corporate finance, a fair degree of regulation, and, in addition, sets forth in clear terms the sanctions imposable upon directors who violate the public trust.

I. *Directors' duty of diligence, care and skill*; *reliance on financial statements*

The insistence by New York courts upon perpetuating the time-worn standard that directors in discharging their responsibilities are summoned to "the same degree of care and prudence that men prompted by self-interest generally exercise in their own affairs" is a prime illustration of the tendency to substitute slogans and clichés for hard thinking and, in the area of business morality and ethics, to articulate a high-flown, abstract ideal that bears little resemblance to reality. That the foregoing standard was originally designed primarily to underline the fiduciary role of the director in relation to the corporation and the body of shareholders, rather than to fix a rigid definition of the directors' duty of diligence and care, is evident in the circumstance that its first definitive formulation in *Hun v. Cary*[221] involved a *banking* corporation. When set forth in that case, in 1880, the standard might well have applied to business corporations of any character (and very likely was so intended)—for the statement of the standard was prefaced by the comment that "when one deposits money in a savings bank, or *takes stock in a corporation*, thus divesting himself of the immediate control of his property, he expects, and has the right to expect, that the trustees or directors, who are chosen to take his place in the management and control of his property, will exercise ordinary care and prudence in the trusts committeed to them"[222] (Emphasis added.)—the business corporation at that time being in a relatively rudimentary state in that closer identity existed between ownership and management and the "outside" director was a rather rare phenomenon. Yet, one wonders whether it is a purely fortuitous circumstance that the preponderant number of cases, after *Hun v. Cary*, in which the standard was restated involved banking institutions, and that in *Kavanaugh v. Commonwealth Trust Co.*[223] the court was inclined to restate the rule in this *qualified* way: "The law governing the duties of directors *in financial institutions* is well settled. [The standard is then set forth.]" (Emphasis added.) The late Justice Sheintag, in *Litwin v. Allen*,[224] discussing in general terms the directors' duty of care, was constrained to say that "undoubtedly, a director of a bank is held to stricter accountability than the director of an ordinary business corporation."

The point of the foregoing comment is that in applying the formula of *Hun v. Cary* out of its context the courts have merely succeeded in foisting on directors of the ordinary business corporation an inflexible standard that is anachronistic in the modern corporate world. This observation was capsuled very neatly by Justice Sheintag in the *Litwin* case:

> It has been said that a director is required to conduct the business of the corporation with the same degree of fidelity and care as an ordinarily prudent man would exercise in the management of his own affairs of like magnitude and importance. General rules, however, are not altogether helpful. In the last analysis, whether or not a director has discharged his duty, whether or not he has been negligent, depends upon the facts and circumstances of a particular case, the kind of corporation involved, its size and financial resources, the magnitude of the transaction, and the immediacy of the problem presented. *A director is called upon 'to bestow the care and skill' which the situation demands.* (Emphasis added.)[225]

The retention by the courts of the old standard constitutes a judicial lag reflecting inadequate perception of the incompatibility between such a stand-

221. 82 N.Y. 65 (1880).
222. Id. at 71.
223. 223 N.Y. 103, 105, 119 N.E. 237, 238 (1918).
224. 25 N.Y.S.2d 667, 678 (Sup. Ct. 1940).
225. Id. at 678.

ard and the development of the modern corporate complex, characterized by the "hybrid" board consisting of the "outside" (advisor, business-connection, prestige) director and the "inside" (management) director. Surely, the law ought take account of the differing roles such directors are intended to (and do in fact) perform (particularly where the corporation, in inducing his presence on the board, represents to the director that his responsibility is coextensive only with the precise function he is requested to perform). Indeed, policy considerations may compel such an approach because, as commentators and the courts have recognized, the outside director, highly reputed in the financial community for general business acumen, may sit as an advisor on a number of boards simultaneously and in such capacity renders invaluable service to the national economy—particularly in cases where the board is composed predominantly of management directors. The appellate court in *Kavanaugh v. Gould*[226] recognized that to expect the same meticulous attention to corporate affairs by all directors irrespective of their intended role is necessarily to discourage competent business men from the performance of this vital service. The court said: "Most of them are directors of more than one corporation, and some of them of many. If they are compelled to supervise the detail management of each corporation in which they are directors, or if they are deemed to have constructive knowledge of such facts as would be acquired by such supervision, it would be wholly impossible for them to accept such a trust . . . . Plaintiff's contention is that they must not then accept the position of director. The obvious answer to this contention is that *the corporation cannot afford to lose them.* One of the best assets of a corporation is the advice and assistance of men of business experience and of large business connections upon its board. Their advice and assistance are of inestimable value in all emergencies and in determining the policies of the corporations and in counsel upon the more important questions that arise. Any construction of the law that would make it impossible for such men to accept positions upon various boards of directors would seriously impair both the effectiveness and stability of corporations, in fact be a little less than calamitous."[227] In *Bates v. Dresser*,[228] the Supreme Court drew the distinction between the outside and inside director and gave it practical implementation by imposing liability in the circumstances on the inside director-president only. Likewise, as far back as *Cassidy v. Uhlmann*[229] the New York Court of Appeals declared that "since a board of bank directors is composed of individuals it is manifest that each director sustains a distinct relation, not only to his bank, but to its stockholders and depositors. For obvious reasons the duties which

226. 147 App. Div. 281, 131 N.Y. Supp. 1059 (3d Dep't 1911).
227. Id. at 289.
228. 251 U.S. 524 (1920).
229. 170 N.Y. 505, 63 N.E. 554 (1902). See also Heller v. Boylan, 29 N.Y.S.2d 653, 700-701 (Sup. Ct. 1944); Broderick v. Horvatt, 148 Misc. 731, 733, 266 N.Y. Supp. 341, 343-4 (Sup. Ct. 1933).

attach to this relation cannot be precisely defined. They cannot be the same under all circumstances; nor can they be imposed with unvarying exactness upon all directors alike."[230]

Section 717 of the Business Corporation Law purports to correct the foregoing obliquities by establishing a standard of conduct for directors that is more consonant with the realities of their situation, and that will provide the courts with a workable tool by which to justify results that presently are often at odds with the theoretical standard on which they are premised. As the writer has suggested in the reviser's note to Section 717, the adoption of the standard that "directors and officers shall discharge the duties of their respective positions in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions" will "allow the court to envisage the director's duty of diligence, care and skill as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director." The court should, under the new standard, be able to consider comfortably such factors as whether the corporation is a banking institution or common-garden-variety manufacturing concern; is the director compensated, an officer, non-resident, primarily valued for his contributions as an expert in a particular area. Has the director functioned only in an advisory role for a number of years? Was this the basis on which he was induced to sit on the board? Under a further provision of Section 717, adapted from Section 43 of the Model Act, directors, acting in good faith, may in discharging their duties rely on financial statements submitted by accredited accountants or corporate fiscal officers. This provision, a practical expedient in the nature of things, codifies existing case law.[231] The reliance must, of course, be in good faith. So, for example, the pattern of circumstances held improper in a case like *Gallin v. National City Bank of New York*,[232] in which directors authorized and accepted without question financial statements involving an incentive compensation plan prepared by corporate officers who stood to benefit from their own handiwork, would undoubtedly be construed as lacking "good faith" under the formula set forth in Section 717. It should be observed that no attempt was made in the new law to formulate a rule authorizing directors to rely in good faith on the advice of counsel—as apparently they may currently by the weight of judicial authority,[233] although

230. Id. at 516, 63 N.E. at 556.

231. Mann v. Luke, 82 N.Y.S.2d 725, 728-9 (Sup. Ct. 1948); Diamond v. Davis, 62 N.Y.S.2d 181, 191 (Sup. Ct. 1945); Myers v. Cowdin, 47 N.Y.S.2d 471, 476 (Sup. Ct. 1944); Epstein v. Schenck, 35 N.Y.S.2d 969, 980 (Sup. Ct. 1939). See also Winkelman v. General Motors Corp., 48 F. Supp. 500, 504 (S.D.N.Y. 1942), aff'd sub nom., Singer v. General Motors Corp., 136 F.2d 905 (2d Cir. 1943).

232. 155 Misc. 880, 281 N.Y. Supp. 795 (Sup. Ct. 1935).

233. Blaustein v. Pan American Petroleum & Transport Co., 293 N.Y. 281, 299-300, 56 N.E.2d 705, 713 (1944); Gilbert v. Burnside, 13 A.D.2d 982, 983, 216 N.Y.S.2d 430, 432 (2d Dep't 1961). See also Spirt v. Bechtel, 232 F.2d 241 (2d Cir. 1956).

there is Court of Appeals authority to the contrary.[234] It is almost too obvious for comment that situations arise in which advice of counsel is indispensable to corporate action. Differently, however, from the case of reliance on financial statements (which is *generally* indispensable to corporate action by directors), whether directors may properly rely on the advice of counsel will normally depend upon the circumstances of the particular case. Accordingly, since this area does not lend itself readily to general formulation, it was left to case by case treatment at the judicial level.

A number of additional matters affecting the duty of directors are noteworthy:

(a) Section 717 makes explicit the requirement that directors discharge their duties with the degree of *skill* ordinarily exercised in similar circumstances by prudent men in like positions. This standard does not purport to codify the intimation in *Hun v. Cary*[235] that directors in assuming the responsibilities of that office *warrant* the possession of ordinary expertise or know-how. It was intended, however, to offset the suggestion made by the Court of Appeals in propounding the "business judgment" rule that a director can be exonerated from liability for errors made in the exercise of an honest, unbiased judgment (presumably arrived at in the exercise of due care)[236] even though the resulting action by the director reveals a total unfitness for the office he has consciously and voluntarily assumed. Thus, in *Everett v. Phillips*,[237] the Court declared: "[y]et, however high may be the standard of fidelity to duty which the court may exact, errors of judgment by directors do not alone suffice to demonstrate lack of fidelity. *This is true even though the errors may be so gross that they demonstrate the unfitness of the directors to manage the corporate affairs.*"[238] (Emphasis added.) Tolerance of such an abysmal standard of competence for managers of giant enterprises—involving

234. People v. Marcus, 261 N.Y. 268, 294, 185 N.E. 97, 105 (1933).

235. Supra note 221. The Court states:

> [L]ike a mandatory to whom he has been likened, he is bound not only to exercise proper care and diligence, but ordinary skill and judgment. As he is bound to exercise ordinary skill and judgment, he cannot set up that he did not possess them.

This "warranty" language was criticized by Judge Learned Hand in Barnes v. Andrews, 298 Fed. 614 (S.D.N.Y. 1924).

236. See Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (Sup. Ct. 1944) in which the court said:

> [T]he question is frequently asked, how does the operation of the so-called "business judgment rule" tie in with the concept of negligence? There is no conflict between the two. When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment—reasonable diligence—has in fact been exercised. A director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said he is exercising business judgment.

But cf., Lattin, Lattin on Corporations 241-242 (1959).

237. 288 N.Y. 227, 43 N.E.2d 18 (1942). See for a similar view of the business judgment rule, Abrams v. Allen, 297 N.Y. 604, 75 N.E.2d 305 (1947); Chelrob, Inc. v. Barrett, 293 N.Y. 442, 57 N.E.2d 825 (1944); Bayer v. Beran, 49 N.Y.S.2d 2 (Sup. Ct. 1944).

238. Supra note 237 at 232, 43 N.E.2d at 20.

stewardship over billions of dollars of public funds—is rather startling and surely impermissible policy for this state. The imposition of a prescribed standard of skill in Section 717 should set the matter straight. Nothing that has been said is intended to suggest that the enactment of Section 717 has entirely eliminated the business judgment rule. That rule remains unaffected by the new law, except to the extent indicated by the foregoing comments.

(b) Other states that have adopted a statutory standard prescribing the duties of directors preface the statement of such standard by providing that "officers and directors shall be deemed to stand in a fiduciary relationship to the corporation. . . ." It will be noted that such a prefatory declaration of the fiduciary relationship of the director to the corporation is absent from Section 717. The reason for the omission is twofold: first, it permits the invalid inference that no similar fiduciary duty exists towards the body of shareholders, the minority shareholder group or, in some cases, the individual shareholders.[239] The suggestion made in some quarters that this dilemma might be solved by expanding the statement of director's fiduciary relationship to the corporation to include shareholders was rejected on the ground that this would unduly extend the duty of directors to the individual shareholder as presently established under case law; second, it permits the undesirable inference that the director is a true trustee, subject to the general rules of the law of trusts. As the preceding discussion of the realistic role of directors in the modern corporate situation has indicated, assimilating the director to the status of a true trustee would be inadvisable. Attention is called in this respect to *sub-paragraph (a) (1) of Section 1005* of the Business Corporation Law which states that directors in liquidating a dissolved corporation "shall not be deemed to be trustees of its assets."

II. *Delegation of the board's authority*; *Executive and other committees*

In these days of mammoth, diversified corporate complexes operated on the committee-line basis, it is particularly important that the outer limits, if any, of permissible delegation by the board of directors of its authority over corporate affairs to an executive committee or other committees be carefully spelled out. It need hardly be noted that it is patently impossible, particularly in large publicly-held corporations, for the board itself to implement on a routine basis such policy as it formulates. Hence, the delegation of routine and ministerial administrative powers to officers and agents is indispensable and, of course, commonplace. In point of fact, even *discretionary* powers may be exercised by more highly-placed officers to the

239. It is, of course, abundantly clear that the directors owe a fiduciary duty to the body of shareholders generally, the minority shareholders (see, for example, Eisenberg v. Central Zone Property Corp., supra note 123), and, in some cases, even to the individual shareholder (see, for example, Saville v. Sweet, 234 App. Div. 236, 254 N.Y. Supp. 768 (1st Dep't 1932), aff'd, 262 N.Y. 567, 188 N.E. 67 (1933). Cf., Section 10(b) of Securities Exchange Act, 1934; Rule X-10B-5).

degree that the courts have recognized the "prima facie" authority of the president (or any officer assuming such status *de facto*)[240] to take any action the board might have authorized or ratified.[240a] This principle recently received a rather unusual application in *West View Hills, Inc. v. Lizau Realty Corp.*[241] in which the Court of Appeals sustained the authority of the president-director to bring suit on behalf of the corporation to surcharge the two remaining directors for dereliction of duty on the ground that such power is impliable where the board has not previously acted to interdict the suit[242] (although it is too obvious to require comment that had the board deliberated in the case the suit would not have been brought).[243] Although existing statutes do not make express provision for the creation of executive or other committees,[243a] the exercise of such power as an administrative expedient was recognized judicially very early,[244] and sustained under the statutory grant of authority to the directors "to appoint such officers and agents as its (corporation's) business shall require." The rationale for sustaining such subdelegation by an apparent corporate agency was explained in the landmark case of *Hoyt v. Thompson's Executor*[245] as resting on the basic principle that the directors are not truly agents of the corporate body receiving their authority from the shareholder-owners, but rather that ". . . the powers of the board of directors are, in a very important sense, original and undelegated. The stockholders do not confer nor can they revoke those powers. They are derivative only in the sense of being received from the State in the act of incorporation."[246]

Limits have been set judicially on the implied power of the president to undertake activity in the management of corporate affairs that involves the exercise of discretion and judgment normally within the sole competence of the board. Thus, in *Heaman v. E. N. Rowell Co.*,[247] the president was held without impliable authority to bind the corporation to a contract hiring an employee for life—although the Court suggested that such authority might have been vested in the president expressly by the board. The Court of Appeals has seemingly never blocked out the extent to which the board is authorized to vest basic policy-making power (extraordinary power as contrasted with

240. See Rothman & Schneider, Inc. v. Beckerman, 2 N.Y.2d 493, 161 N.Y.S.2d 118 (1957).

240a. Hardin v. Morgan Lithograph Co., 247 N.Y. 332, 160 N.E. 388 (1928).

241. 6 N.Y.2d 344, 189 N.Y.S.2d 863 (1959).

242. See Sterling Industries, Inc. v. Ball Bearing Pen Corp., 298 N.Y. 483, 84 N.E. 2d 790 (1949) in which the Court of Appeals held the president without power to initiate suit on behalf of the corporation where the board had considered the advisability of bringing suit and had not authorized it (because it was deadlocked).

243. See In re Paloma Frocks, Inc., 3 N.Y.2d 572, 170 N.Y.S.2d 509 (1958), where Sterling Industries, Inc. was distinguished on the ground that the advisability of bringing suit had not been considered by the board and rejected (as in Sterling Industries).

243a. Except for N.Y. Gen. Corp. Law § 31 which refers to "the board of directors or any committee thereof." See N.Y. Membership Corp. Law § 20.

244. Hoyt v. Thompson's Executor, 19 N.Y. 207 (1859).

245. Ibid.

246. Id. at 216.

247. 261 N.Y. 229, 185 N.E. 83 (1933).

power to make decisions involving the exercise of some discretion or judgment) in corporate officers or the executive committee. In theory, such extraordinary (policy-making) power ought not be exercised by a committee constituting less than the entire number of authorized directors since, under Sections 27 and 28 of the General Corporation Law and parallel provisions of the new law,[247a] management power over corporate affairs is vested in the directors, regularly convened as a *board,* and it has been consistently held that Section 27 embodies fundamental public policy.[248] Certainly, in the light of this policy, the executive committee should be subordinate to the full board, which ought have the right in every case to override any policy decisions made by the committee. Such, indeed, was held to be the case in *Commercial Wood and Cement Company v. Northhampton Portland Cement Company.*[249] Insofar as the New York courts have expressed any views on the question posed above, they have uniformly taken the position that extraordinary powers cannot be delegated to the executive committee.[250] This rule was stated most forthrightly by a lower court in *Fensterer v. Pressure Lighting Co.*[251] as follows: "The vesting in an executive committee of the powers of the full board of directors as to the *'management of the business and affairs'* of the company cannot be construed to empower the executive committee to remove from office statutory officers of the company who have themselves been elected for a prescribed tenure by the full board of directors. Assuming that such a power is one which the statute might authorize to be delegated—and this I doubt—such a delegation may not be inferred from less than a clear expression of the legislative intent and an explicit provision of the by-laws and resolution. Such an expression as 'the powers of the board of directors in the management of the business and affairs of the company' may be held to delegate *'ministerial,' 'current', 'ordinary' and 'routine' powers, but not power to inaugurate radical reversals of or departures from fundamental policies and methods of conducting the business as prescribed by the directorate.*" (Emphasis added). The decisive New York precedent sustaining the propriety of board delegation of its authority to an executive committee, *Hoyt v. Thompson's Executor,*[252] itself distinguished between "ordinary" and "extraordinary" business for this purpose, and although it interpreted "ordinary business" very broadly, making it coterminous with "the varied and extensive affairs in which it was authorized by its charter to engage," there is nothing in the opinion to suggest that the Court recognized any

247a. See, N.Y. Bus. Corp. Law §§ 701, 708.

248. See Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936).

249. 190 N.Y. 1, 82 N.E. 730 (1907).

250. See First National Bank v. Commercial Travelers' Home Ass'n of America, 108 App. Div. 78, 95 N.Y. Supp. 454 (3d Dep't 1905), aff'd, 185 N.Y. 575, 78 N.E. 1103 (1906); Fensterer v. Pressure Lighting Co., 85 Misc. 621, 149 N.Y. Supp. 49 (City Ct. 1914), appeal denied, 167 App. Div. 904 (1st Dep't 1915).

251. Supra note 250.

252. Supra note 244.

authority in the committee to establish fundamental policy for the corporation. The suggestion that language in *Manson v. Curtis*[253] to the effect that "the directors convened as a board are the primary possessors of all the powers which the charter confers, and *like private principals* they may delegate to agents of their own appointment the performance of any acts which they themselves can perform, and that the recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors"[254] (Emphasis added.) may have relaxed the foregoing rule is not convincing—if only because the precedent cited to sustain the court's comment is *Hoyt v. Thompson's Executor.* The exercise by an executive committee of extraordinary power has been denied where it sought to: issue corporate shares (although the committee had been vested with the power of general direction and superintendence of the affairs of the company and with full authority for constructing, repairing, equipping and operating the railroad);[255] discharge statutory officers designated by the full board;[256] vote its own compensation;[257] bind non-assenting shareholders to a merger;[258] bind the corporation to a selling agency for a period of five years (the court suggested that the exercise of such extensive power could not be implied).[259]

Aside from the limitations imposed judicially on the permissible scope of executive committee powers, the evidence is strong that the boards of many corporations jealously reserve extraordinary powers to themselves. This reservation normally takes the form of a provision in the constating resolution or by-law to the effect that "the authority of the committee is restricted to the ordinary and usual business of the company," or "the executive committee shall possess and exercise the authority of the board in the management of the affairs of the corporation only to the extent that specific directions shall not have been given by the board," or "the executive committee shall transact the ordinary business of the corporation during the interval between meetings of the board, subject at all times to the control of the board."[260] Most often the restriction takes the form of specifically enumerated exceptions to the committee's authority involving such matters as: adoption, amendment or repeal of by-laws; declaration of dividends; filling of vacancies in the board or committees; election or removal of officers; amendment of the certificate of incorporation; recommendation to shareholders of any action requiring their

253. 223 N.Y. 313, 119 N.E. 559 (1918).
254. Id. at 322, 119 N.E. at 562.
255. Ryder v. Bushwick Railroad Co., 134 N.Y. 83, 31 N.E. 251 (1892).
256. Fensterer v. Pressure Lighting Co., supra note 250.
257. Marshall v. Industrial Federation of America, 84 N.Y. Supp. 866 (App. T. 1903).
258. Blatchford v. Ross, 54 Barb. 42 (N.Y. 1869).
259. Commercial Wood and Cement Co. v. Northampton Portland Cement Co., supra note 249.
260. See American Society of Corporate Secretaries, Inc. and National Industrial Conference Board, Inc., Corporate Directorship Practices (Studies in Business Policy, No. 90), 67 (1959).

approval; issuance of additional shares; embarking on major financing; fixing compensation of directors and officers. It is customary for the committee to report on its actions to the full directorate, and many by-laws stipulate that any action taken by such committee shall be subject to modification or abrogation by the full board.[261]

The foregoing account of the current status in New York of the executive committee should serve to point up the importance of *Section 712* of the Business Corporation Law, which gives statutory recognition to the executive committee and other committees.[262] *Paragraph (a)* authorizes the board to act through a committee of at least three directors, if the certificate of incorporation or the by-laws so provide, pursuant to a resolution adopted by a majority of the entire board (which is defined in paragraph (a) of Section 702 as "the total number of directors which the corporation would have if there were no vacancies"). Of course, the essence of Section 712 lies in its flat statement that such executive or other committee "to the extent provided in the resolution or in the certificate of incorporation or by-laws, *shall have all the authority of the board . . . ,*" subject to the enumerated exceptions. That this formulation was designed to authorize delegation to the executive or other committees of extraordinary (policy-making) powers—which the language declares so directly—is evidenced by its scrupulous avoidance of the former Model Act language "shall have and may exercise all of the authority of the board of directors *in the management of the corporation. . . .*" This latter language (eliminated from the Model Act in the 1959 amendments thereto) had been included in preliminary drafts of Section 712, but was excluded from the prefiled version of the (1960) Study Bill because of its tendency to suggest that only a restrictive delegation of ordinary and routine management powers was intended to be authorized. Further evidence of the legislative intention to allow a more dimensional delegation to committees of the board's authority is to be found in the character of the exceptions to such delegation embodied in the section. These include corporate policy matters of great importance (of the kind which, as indicated above, boards of many companies tend to reserve to themselves in any event) such as: (1) the submission to shareholders of any action that needs their authorization under the chapter (this would include mergers, consolidations, disposition of all or substantially all the corporate property, amendments of the certificate of incorporation, loans to directors, ultra vires guarantees, director, officer or employee incentive share option plans, informal dissolution, contracts or transactions involving interested directors and their corporations, indemnifications of directors and officers, and share distributions in certain cases); (2) the filling of vacancies in the board or any

261. Id. at 68-69.

262. Although stress is placed in this discussion on the executive committee, the importance of other committees, such as the finance and audit committees, in organizations run on the committee-line is not unrecognized.

committee; (3) fixing the compensation of the directors for serving on the board or any committee; (4) the adoption, amendment or repeal of by-laws; and (5) amending or repealing any board resolution by its terms unamendable or unrepealable. Although the foregoing exceptions to the delegation power of the board are extensive, many vital matters affecting corporate policy remain within the area of permissible delegation, such as the declaration of dividends, the issuance of shares, major corporate financing, the designation and removal of officers, the hiring, firing and compensation of corporate personnel, and the like. It is important to note in this respect that, as formulated in Section 712, aside from the enumerated statutory exceptions, the executive committee will be conclusively presumed to have all the authority of the full board except as to particular areas of authority expressly excluded from the delegation in the certificate of incorporation, by-law or resolution creating the committee. Hence, *committee action is corporate action* and irreversible as such by the full board, except as the board may have reserved the right to amend or revoke the acts of committee that it appoints. Since, however, under *paragraph* (*c*), any committee designated by the board *serves at its pleasure*, the board would as a practical matter have the power to remove any committee and, if third party rights are not involved, undo any act of such committee of which it does not approve.

The extent to which the full board should be chargeable with the improprieties of a committee that it selects presents a problem of not inconsiderable difficulty, the solution of which depends in good measure upon the view taken of the relationship between the board and its committees. If such relationship is viewed in terms of principal-agent (a natural assumption since, under paragraph (c), the committee is expressly stated to serve at the pleasure of the board), the board should, technically, be responsible for any dereliction by its agent (the committee) despite the most extreme care taken in selecting it. If, however, the committee, once designated, is viewed as an independent body, a plausible argument can be advanced that the board should be responsible only for failure to exercise proper care in selecting such committee. This latter assumption carries the necessary consequence that the full board might escape responsibility for many important actions, affecting vital corporate policy within the area of permissible delegation, by the simple expedient of creating a three-man committee. Public policy considerations would appear to require some compromise of these opposing views, and the ultimate responsibility of the particular director (who is not on the committee) for actions taken by the committee might well be made to depend upon his role in corporate management. The "outside" director should clearly not be burdened with the need to supervise details of management by which established policy is administered, although the extent of the duty of the "inside" (management) director in this respect is not so clear.[263] Similar considerations very likely apply to the com-

263. See Bates v. Dresser, supra note 228.

mittee's formulation of minor areas of corporate policy inevitably involved in the routine of corporate administration. But, surely, there can be no argument with the proposition that the entire board owes a continuing duty of supervision over, and should bear continuing responsibility for, the *major areas* of corporate policy, such as dividend declarations and financing mechanisms, despite the permissible delegation of such policy-formulating power to a committee of its choice. The mere circumstance that the new law authorizes (probably for the first time in New York) the delegation of major policy-making power to a committee does not justify the abdication by the board of, what in Section 717 is declared to be, its duty to discharge its office "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." Case law is not to the contrary.[264] The highest courts have uniformly taken the view that the board in delegating authority to committees or officers does not thereby cast off its responsibility for general supervision over, and formulation of, major policy matters. This position was taken forthrightly in *Kavanaugh v. Commonwealth Trust Co.*,[265] in an elaborate opinion in which the lower court commented as follows:

> Directors, not members of the executive committee, are not excused from liability because they committed their duties to the executive committee and relied upon them to examine the loans and collateral. The stockholders elected the directors, not the executive committee; and, if the directors saw fit to rely on the executive committee, it was their own reliance and their own risk. They may delegate the work, not their responsibility.[266]

Although it is true that the lower court judgment was reversed and a new trial ordered in *Kavanaugh v. Gould*,[267] the position taken by the lower court, imposing responsibility on *non-committee* members of the board for improper loans and other distributions tolerated by the committee, was sustained by the result reached in the Court of Appeals[268] when the matter finally got there for decision. In any case, a close reading of the majority opinion in *Kavanaugh v. Gould* does not reveal any theoretical opposition to the residual responsibility of the board for major corporate policy. While the majority there disagreed with the lower court's general statement that the board "may delegate the work but not the responsibility" and took the square position that the board would, as a matter of the general law of trusts, not be responsible for the

264. See Cassidy v. Uhlmann, supra note 229; Kavanaugh v. Commonwealth Trust Co., supra note 223; see also Briggs v. Spaulding, 141 U.S. 132 (1890); Warner v. Pennoyer, 91 Fed. 587 (2d Cir. 1898).

265. 64 Misc. 303, 118 N.Y. Supp. 758 (Sup. Ct. 1909).

266. Id. at 316, 118 N.Y. Supp. at 767.

267. 147 App. Div. 281, 131 N.Y. Supp. 1059 (3d Dep't 1911), reversing, Kavanaugh v. Commonwealth Trust Co., supra note 265.

268. Kavanaugh v. Commonwealth Trust Co., supra note 223, reversing, 169 App. Div. 905, 153 N.Y. Supp. 1122 (3d Dep't 1915) (same case, which had gone back for new trial after the reversal in Kavanaugh v. Gould, supra note 267).

negligent performance of the work that it may permissibly delegate, it is abundantly clear, contextually, that the court's reference to "work" was to "routine" management of the corporation, and to "delegation" was to the delegation of ministerial duties of management—not major policy formulation (not involved factually in the case).

The foregoing discussion should serve to illuminate the inclusion in paragraph (c) of the provision that "the designation of any such committee and the delegation thereto of authority shall not alone relieve any director of his duty to the corporation under Section 717." This formulation is designed to afford the court sufficient flexibility, in fixing responsibility for improprieties committed by a committee, to recognize the continuing duty of the board in respect of the important areas of corporate policy but to restrict, to members of the committee only, responsibility for negligence and breach of duty in the execution of corporate policy and in the routine of daily administration of the corporate affairs. This flexibility would extend as well to the definition of the *relative* duties under Section 717 of "outside" and "inside" directors. The formulation found in Section 38 of the Model Act, which had been incorporated into the (1960) Study Bill, that "The designation of any such committee and the delegation thereto of authority shall not operate to relieve the board of directors, or any member thereof, of any responsibility imposed by law" was rejected, after more mature deliberation, as too broad a statement of the residual responsibility of the board for the acts of the committee. Such a standard, if taken by the courts at face value (and no reason appears why it should not be), would require the imposition of liability upon the full board for any improprieties of the committee in its day-to-day conduct of the business of the corporation, and would have the necessary consequence of discouraging men of affairs from manning the boards of corporations in this state.

III. *Directors' Rights*; *Interested Directors*; *Indemnification*

A. *Interested directors*

The notoriety attendant upon the rash of "conflict of interest" situations in public life and, particularly, in large public-issue corporations underlines the need for a precise definition of the extent to which a director may deal with his corporation in relation to a matter in which the director is personally interested. This question, a facet of the duty of loyalty owed by the director to his corporation, has been complicated by an early ill-conceived identification of the corporate director with the *strict* (or technical) trustee. In *Munson v. Syracuse, Geneva and Corning Railroad Co.*,[269] plaintiff sought to compel the specific performance of a contract he (and his associates) had made with the defendant corporation (of which plaintiff was a director). The contract involved the sale of railroad properties and rights of way owned by Munson and his associates

269. 103 N.Y. 58, 8 N.E. 355 (1886).

to the corporation. The court's refusal to grant specific performance was justified by the rationale embodied in the following comment:

> . . . the contract . . . is repugnant to the *great rule of law* which invalidates all contracts made by a *trustee* or fiduciary in which he is personally interested, at the election of the party he represents. There is no controversy as to the facts bringing the case as to Munson within the operation of the rule. He and his associates were dealing with a corporation in which Munson was a director, in a matter where the interests of the contracting parties were or might be in conflict. The contract bound the corporation to purchase, and Munson, as one of the directors, participated in the action of the corporation in assuming the obligation. . . . He stood in the attitude of selling as an owner and purchasing as trustee. The law permits no one to act in such inconsistent relations. *It does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without undertaking to deal with the question of abstract justice in the particular case. It prevents frauds by making them, as far as may be, impossible,* knowing that real motives often elude the most searching inquiry, and it leaves neither to judge nor jury the right to determine upon a consideration of its advantages or disadvantages, whether a contract made under such circumstances shall stand or fall. . . . The law cannot accurately measure the influence of a trustee with his associates. . . . *The value of the rule of equity, to which we have adverted, lies to a great extent in its stubbornness and inflexibility.* (Emphasis added.)[270]

The foregoing "great rule of law" doctrine was restated by the Court of Appeals as recently as 1952 in the case of *In re People (Bond and Mortgage Guarantee Co.)*[271] (which, however, involved improprieties by attorneys for (strict) trustees who had been appointed for the benefit of holders of first mortgage certificates in a corporate reorganization). It should be noted, however, that the reaffirmance of the Munson doctrine in *In re People (Bond and Mortgage Guarantee Co.)* was the basis for a sharp dissent in the significant Appellate Division, Second Department case of *La Vin v. La Vin*[272] which shall be discussed later.

Although the Munson doctrine was tacitly reaffirmed as a controlling precedent by the Court of Appeals in a number of cases,[273] "cross-currents and eddies" in other opinions by the same court muddied the stream, and served to confound the practising bar. Thus, in *Converse v. Sharpe*,[274] it was held that

270. Id. at 73, 74, 8 N.E. at 358.
271. 303 N.Y. 423, 103 N.E.2d 721 (1952).
272. 283 App. Div. 809, 128 N.Y.S.2d 518 (2d Dep't 1954), aff'd, 307 N.Y. 790, 121 N.E.2d 620 (1954).
273. See New York Trust Co. v. American Realty Co., 244 N.Y. 209, 155 N.E. 102 (1926); Globe Woolen Co. v. Utica Gas & Electric Co., 224 N.Y. 483, 121 N.E. 378 (1918).
274. 161 N.Y. 571, 56 N.E. 69 (1900).

a director could in good faith loan money to his corporation and take corporate securities as collateral (even though it later developed that the corporation was in fact insolvent when the loan was made). The Court relied on *Twin-Lick Oil Company v. Marbury*[275] in which the Supreme Court had declared that there was no rule forbidding a director "from loaning money to the corporation when the money is needed, and the transaction is open and otherwise free from blame." In *Gamble v. Queens County Water Co.*,[276] the Court refused to enjoin the consummation of a transaction in which a director-shareholder sold a water-works extension that he had built and owned to his water-works corporation. The Court was able to say, without either mention of, or attempt to distinguish the *Munson* case, that "this is not the case of a trustee entering into a contract with himself or purchasing from himself, where the contract is liable to be repudiated at the mere will or even the whim of the *cestui que trust*. Having the rights of an absolute owner of this extension, Mullins was at liberty in making such contract in regard to its disposal as he should see fit, so long, of course, as he did not, while acting in his own interest on the one side, also act on the other in the capacity of trustee or representative, so that his interest and his duty might conflict. In this case Mullins did not so act."[277] This comment, coming right on the heels of the decision in *Munson*, is rather perplexing unless it be assumed that the *Munson* case has no force as a precedent where the interested director does not participate (as he did in *Munson*) in the decision of the board approving the contract. An attempt to reconcile the *Munson* and *Gamble* cases on this ground was flatly rejected by the Court in *Globe Woolen Co. v. Utica Gas and Electric Co.*[278] in the following interesting statement by Judge Cardozo: "We think the evidence supports the conclusion that the contracts are voidable at the election of the defendant. The plaintiff does not deny that this would be true if the dual director had voted for their adoption (Munson v. Syracuse, G. & C.R.R. Co.). But the argument is that by refusing to vote, he shifted the responsibility to his associates, and may reap a profit from their errors. One does not divest oneself so readily of one's duties as trustee. The refusal to vote has, indeed, this importance: It gives to the transaction the form and presumption of propriety, and requires one who would invalidate it to probe beneath the surface. . . . But 'the great rule of law' (Andrews, J., in Munson v. Syracuse, G. & C.R.R. Co. . . .) which holds a trustee to a duty of constant and unqualified fidelity is not a thing of form and phrases. A dominating influence may be exerted in other ways than by a vote."[279] (Citation omitted.) How, indeed, in light of *Munson*, can one explain the following language of the Court of Appeals in *Billings v.*

275. 91 U.S. 587 (1875).
276. 123 N.Y. 91, 25 N.E. 201 (1890).
277. Id. at 97, 25 N.E. at 201, 202.
278. Supra note 273.
279. Id. at 488, 489, 121 N.E. at 379, 380.

Shaw:[280] "The illegality of a profit made by a director arises almost wholly by reason of some undisclosed and secret bias on his part against the interest of the corporation of which he is a director. If a profit is made in a transaction that is honest in itself, and is open and fully disclosed, and the transaction is consummated after an honest statement of the facts to the board of directors at a meeting, and to the stockholders at a stockholders' meeting there is no reason for criticism or for charging such director with any profits that he may make."[281] The position reflected in the foregoing language of *Billings v. Shaw* was later squarely implemented in *New York Trust Co. v. American Realty Co.*,[282] in which a director was allowed to retain a profit he had made from a sale of timberland that he owned to his corporation on the ground that although the corporation might have rescinded the contract (citing the *Munson* case for this proposition), it could not "repudiate the obligations of a contract made with a director and at the same time retain its benefits. If contract with the director was valid, the corporation must pay the agreed price; if invalid, the corporation must rescind or repudiate the contract in its entirety. . . . Profit made is the fruit of his ownership, and not his agency. . . . If the contract which fixed the amount of the seller's profits is not rescinded or void, the fact that the profits are so large that they might be called 'exorbitant' is ordinarily immaterial."[283]

The authorities discussed above involved transactions between the director and his corporation in which the subject matter was property owned by the director in his personal right. A line of cases appeared very early which involved transactions between corporations having common directors—the "interlocking directorate" situation. These cases, originally decided compatibly with *Munson*, soon departed from the rigidity of the doctrine. In an elaborate opinion at special term in 1884, *Metropolitan Elevated Railway Co. v. Manhattan Elevated Railway Co.*,[284] the Court reviewed the precedents in depth and found that they imposed upon the director transacting the business of the (corporate) trust the responsibilities of a strict trustee. When urged to distinguish between corporate transactions involving common directors and those in which the director contracts with his corporation as to a matter in which he is personally interested, the Court concluded "I can see no difference in principle between the case of a director contracting with his corporation and that of directors of one corporation contracting with themselves as directors of another corporation. The evils to be avoided are the same; the temptations to a breach of trust are the same; the want of independent action exists, and the divided allegiance is just as apparent."[285] However, in *Sage v. Culver*, decided in

280. 209 N.Y. 265, 103 N.E. 142 (1913).
281. Id. at 280, 103 N.E. at 147.
282. Supra note 273.
283. Id. at 217, 218, 155 N.E. at 105.
284. 11 Daly 373 (N.Y. 1884).
285. Id. at 503.

1895, a derivative action was brought against the directors—majority shareholders of a railroad corporation alleging in part that the defendants had taken a lease for their corporation at exorbitant rentals from another railroad in which they were likewise directors and majority shareholders.[286] Without even a wisp of reference to *Munson* or earlier precedents, the Court stated: "When a trustee or the officer or director of a corporation deals with himself, as an individual, or in the character of trustee, director, or officer of another corporation, with respect to the funds, securities or property of the corporation, *the transaction is at least open to question by the corporation, or, in a proper case, by its stockholders, and the trustee is bound to explain the transaction, and show that the same was fair, and that no undue advantage has been taken by him of his position, for his own advantage, or the advantage of some other corporation in which he has an interest*. . . . When it appears that the trustee or officer has violated the moral obligation to refrain from placing himself in relations which ordinarily produce a conflict between self-interest and integrity, there is, in equity, a presumption against the transaction, which he is required to explain."[287] (Emphasis added.) There is, in the foregoing comment, no intimation that a transaction involving an interested director and his corporation or between corporations having common directors is voidable at the option of the corporation adversely affected—but only that a presumption of possible impropriety is created thereby which the interested director has the burden of explaining. In *Globe Woolen Co. v. Utica Gas and Electric Co.*,[288] involving a suit for the specific performance of a contract between a corporation owned by one Maynard and another corporation of which he was a director, Judge Cardozo, speaking for the Court, paid lip service to *Munson* but actually held the contract unenforceable against the corporation (or avoidable by it) only after a thorough factual analysis of its fairness to the corporation. There was no suggestion in the case that the transaction was automatically avoidable by the corporation irrespective of its fairness—quite the contrary, for the Court was moved to say "(W)e think *the evidence supports the conclusion* that the contracts are voidable at the election of the defendant." (Emphasis added.) The evidence, going beyond the mere inconsistent position of the common director, probed the special character of the transaction, the influence exerted by Maynard on the corporate officer in charge of the transaction and other relevant factors. Finally, in *Everett v. Phillips*,[289] an action was commenced to compel the directors of the Empire Power Corporation to collect loans that had been made to the Long Island Lighting Company. The defendants were on the boards of both corporations in which they owned controlling share interests. When it was argued that the transactions between the corporations having common directors was voidable without regard to their fairness to

286. 147 N.Y. 241, 41 N.E. 513 (1895).
287. Id. at 247, 41 N.E. at 514.
288. Supra note 273.
289. 288 N.Y. 227, 43 N.E.2d 18 (1942).

Empire Power, the court said: "It is argued, however, that the transactions in which the defendants acted as directors both of the Empire Power Corporation and the Long Island Lighting Company should be set aside because the dual position of these directors precluded an unprejudiced exercise of judgment. *The dual position of the directors making the unprejudiced exercise of judgment by them more difficult, should lead the courts to scrutinize these transactions with care* (Sage v. Culver . . .). *It does not, however, alone suffice to render the transactions void. . . .*"[290] (Emphasis added.) The court also held that a provision of the certificate of incorporation of Empire Power expressly authorizing the directors to act even with respect to matters in which they have a dual interest "has the effect of exonerating the directors, at least in part, 'from adverse inferences which might otherwise be drawn against them.'"[290a]

At least insofar as transactions between corporations having common directors are involved, the "prophylactic doctrine"[291] of *Munson* was, if not directly overruled, effectively relegated to limbo by *Everett v. Phillips.* This was recognized by the federal court in *Piccard v. Sperry,*[292] where in a suit to surcharge a director of the Sperry corporation for profits derived from bringing his corporation into contractual relations with another corporation of which he was president and principal shareholder, the court viewed the New York law in the conflict of interest area as follows: "To the extent that *Munson v. Syracuse, G. & C.R.R. Co.* may be said to impose a more rigid standard, it yields to the more moderate view expressed by both prevailing and dissenting opinions in Everett v. Phillips."[293] (Citations omitted.) The New York appellate courts, in a line of cases involving factual patterns of both the *Munson* and *Phillips* variety, have with undeviating uniformity followed the lead of the *Phillips* case. A number of these cases were affirmed without opinion by the Court of Appeals.[294] One of the most recent of these, and perhaps the most revealing because of the split it induced in the court on the law governing the conflict of interest issue, is *La Vin v. La Vin*[295] which involved an action by a minority shareholder to set aside a lease made by defendants (directors-majority shareholders) to a third party, from which the defendants had allegedly extracted personal gain. The majority relied squarely on *Everett v. Phillips* in holding that a showing of personal benefit to a director from a corporate

290. Id. at 236, 237, 43 N.E.2d at 22.
290a. Id. at 237, 43 N.E.2d at 22.
291. This phrase has been attributed to Professor Ballantine.
292. 48 F. Supp. 465 (S.D.N.Y. 1943), aff'd, 152 F.2d 462 (2d Cir. 1946).
293. Id. at 467.
294. La Vin v. La Vin, supra note 272; Martin Foundation, Inc. v. Phillips-Jones Corp., 283 App. Div. 729, 127 N.Y.S.2d 649 (2d Dep't 1954), aff'd, 306 N.Y. 972, 120 N.E.2d 230 (1954); Garbarino v. Utica Uniform Co., 269 App. Div. 622, 58 N.Y.S.2d 136 (4th Dep't 1945), aff'd, 295 N.Y. 794, 66 N.E.2d 579 (1946). See also Tomarkin v. Vitron Research Corp., 12 A.D.2d 496, 206 N.Y.S.2d 869 (2d Dep't 1960); Wohl v. Miller, 5 A.D.2d 126, 169 N.Y.S.2d 233 (1st Dep't 1957); In re Curran, 203 Misc. 956, 120 N.Y.S.2d 207 (Surr. Ct. 1953); In re Meyer's Estate, 119 N.Y.S.2d 737 (Surr. Ct. 1953).
295. Supra note 272.

transaction does not as a matter of law invalidate it, and that a declaration of invalidity based upon bad faith and unfairness to the corporation involved a question of fact which had been decided in favor of defendants by the trial court. The dissenting (presiding) justice refused to concede that *Munson* had been eviscerated by *Phillips*, particularly in light of *Munson's* very recent indorsement by the Court of Appeals in *In re People* (*Bond & Mortgage Guarantee Co.*),[296] and sought to distinguish *Phillips* on a number of grounds including the circumstance that the certificate of incorporation of Empire Power Corporation in that case authorized intercorporate transactions by common directors.

Analysis of the foregoing crazy-quilt of authority reveals that *Munson v. Syracuse, Geneva and Corning Railroad Co.*[297] stands in "lofty" isolation in the conflict of interest arena. This is hardly surprising in light of its unrealistic equation of the corporate director and the strict (technical) trustee. The courts realized around the turn of the century, when business was in its rapidly expanding state and property interests were proliferating, that enterprises in difficulty might have to turn for assistance to their managers (*Converse v. Sharpe*)[298] or enter into profitable or necessary transactions involving property owned by such managers personally (*New York Trust Co. v. American Realty Co.*).[299] In such case, although the interested director is a fiduciary and must transact business with his corporation scrupulously, the effect of imposing the strict trusteeship formula of *Munson* is to throttle many such transactions in their very inception. It is very likely that *Munson* has not been formally overruled in its application to corporate-interested director transactions because of its salutary *indirect* effect upon such transactions, and because of its general tendency, as an extant precedent, to underline the fiduciary responsibility of the director.

Section 713 of the Business Corporation Law, modeled after a California statute,[300] was drafted with a view to stabilizing the law affecting conflict of interest questions. In *paragraph* (*a*), the essential approach of *Everett v. Phillips* is adopted by the provision that no contract or transaction between a corporation and its director or between a corporation and another firm in which its director is likewise a director or officer or financially interested shall be either void or voidable for this reason alone, or for the reason alone that the corporate director was present at a meeting of the board or committee which approved the contract or transaction or that his vote was counted for such purpose. However, to insure that the conflict of interest will not alone suffice to set aside the transaction, any one of the following three conditions must be met: (1) Under *subparagraph* (*a*) (*1*) if the interest or common directorship is disclosed or known to the board or committee, such contract or transaction may

296. Supra note 271.
297. Supra note 269.
298. Supra note 274.
299. Supra note 273.
300. Cal. Gen. Corp. Law § 820.

be approved by such board or committee by a sufficient vote without counting the vote of the interested director. Under *paragraph (b)*, common or interested directors *may* be counted in determining the presence of a quorum at a meeting at which the contract or transaction is approved. Although this latter provision would appear to depart from the common law rule in New York,[300a] it has the advantage of making essential corporate-interested director transactions possible, which could not have been considered at all under the common law rule because no quorum could be convened. This result is of particular moment for the close and medium-size corporations where directors are often the principal owners of the enterprise and corporate financing may depend upon loans from the owners. (2) Under *subparagraph (a) (2)*, if the interest or common directorship is disclosed or known to the shareholders entitled to vote, such contract or transaction may be approved by vote of the shareholders (which, under *paragraph (b) of Section 614* of the Business Corporation Law, would require for this purpose "a majority of the votes cast at a meeting of shareholders [at which a quorum is present] by the holders of shares entitled to vote thereon"). This provision for shareholder authorization of corporate-interested director transactions is compatible with the common law rule, set forth in such cases as *Continental Securities v. Belmont*,[301] that "irregular" or "voidable" (as contrasted with illegal or fraudulent) transactions could be "ratified or confirmed by a majority of the body of stockholders as the ultimate parties in interest and thus make them binding on the corporation." The same authorities make it abundantly clear, however, that such ratification or confirmation would not *validate* any fraud, misapplication of funds, or overreaching by interested directors, at least so as to bind the minority shareholders who had not assented thereto. Subparagraph (a) (2) contains the additional provision, *at variance with the common law rule*,[302] that for the purpose of obtaining such shareholder approval "the share of such interested director or directors shall not be shares entitled to vote." In addition to stripping such shares of voting rights, the effect of this provision is to exclude the shares owned by interested directors from being counted in determining the presence of a quorum (since under *paragraph (a) of Section 608* of the Business Corporation Law, a quorum is constituted by the holders of a majority of the *shares entitled to vote*—which would necessarily exclude the shares of interested directors denominated "shares not entitled to vote" in subparagraph (a) (2)). Since shares of interested directors could not be counted toward a quorum at shareholders' meetings, this latter provision of subparagraph (a) (2) might have the unfortunate effect in some cases of preventing the consummation of such

300a. See Enright v. Hecksher, 240 Fed. 863 (2d Cir. 1917); Butts v. Wood, 37 N.Y. 317 (1867). Cf., Piccard v. Sperry, supra note 292.

301. Supra note 36.

302. See Gamble v. Queens County Water Co., supra note 276. It is interesting to note that the director-shareholder is not barred from exercising his franchise as a shareholder under the California statute which inspired Section 713.

transactions as sales, mergers and consolidations in certain close or medium-size corporations in which the interested directors own a substantial majority of the shares but cannot control the minority shareholders whose presence would be indispensable to a quorum. This possibly burdensome consequence, in addition to depriving the interested director of his franchise as a shareholder, would seem an unduly high price to exact for a policy aimed at preventing the interested director from exerting an influence as a shareholder on the vote of the shareholder body affecting the transaction in which he is interested—particularly when it is considered that Section 713 is concerned solely with the *voidability* and not the *validity* (or director-liability consequences) of such corporate-interested director transactions.[303] (3) Despite the absence of any disclosure of the interest or common directorship, the contract or transaction will not be void or voidable by reason thereof "if the contract or transaction is fair and reasonable as to the corporation *at the time it is approved* by the board, a committee or the shareholders." (Emphasis added.) This provision embodies the essential holding of *Sage v. Culver*[304] and *Everett v. Phillips*[305] to the effect that an action to set aside the contract or transaction ought to fail if the interested director can sustain the burden of demonstrating that he has not taken improper advantage of his special position in the corporation and that, in general, the transaction is one which the corporation could profitably, and would likely, have made in the same way with a stranger. An assessment of the corporate need for the transaction and the adequacy of the consideration received by the corporation therefrom, in light of all relevant surrounding circumstances, will, of course, be of prime importance. The failure of the director to disclose his interest and the general influence he exerts on the board will be involved at least tangentially in determining whether the transaction should be set aside.

It is extremely important to recognize that the *sole* function Section 713 is designed to subserve is simply to eliminate the *Munson*[306] case as a controlling precedent, and to establish beyond question that a contract or transaction between a director and his corporation or between corporations having common directors shall not be void or voidable *for this reason alone* if either of the "disclosure" criteria or the "fairness" test is met. Mere compliance with the disclosure requirement would not, however, prevent the avoidance of such contract or transaction for fraud or other impropriety. In fact, the experience with the California statute, almost the verbatim counterpart of Section 713, indicates that the "fairness" test will probably be held to blanket the statute; that is, despite technical compliance with the disclosure requirement (which will prevent avoidance of the contract or transaction by reason

303. An amendment to Section 713 eliminating the second sentence of subparagraph (a) (2), which disallows the interested director from voting as a shareholder, has been approved at the 1962 session of the New York Legislature.
304. Supra note 286.
305. Supra note 289.
306. Supra note 269.

of the director's interest), the contract or transaction may still be set aside if unfair to the corporation when approved. This was the square holding in *Remillard Brick Co. v. Remillard-Dandini Co.*[307] where the court in construing the California statute held the fiduciary responsibilities of the interested directors of transcendent importance, and stated that "even though the requirements of section 820 are technically met, transactions that are unfair and unreasonable to the corporation may be avoided." *Section 713 does not purport to deal with the validity of the contract or transaction*, and mere disclosure of a director's interest will not alone serve to validate such a contract or transaction where there is evidence that the disclosure was not full and fair, unfair advantage was taken by the interested director, or some other impropriety or fraud characterized his dealings with the corporation. Nor will members of the board who breach their duty as defined in Section 717 in approving such a contract or transaction be exonerated from liability for their conduct because there has been a technical compliance with Section 713. In *Kennerson v. Burbank Amusement Co.*,[308] an appellate court in California invalidated a contract between an interested director and his corporation on the ground that there had been an improper delegation under the contract of the board's function to govern. The court quoted the *Remillard* case to the effect that "neither section 820 of the Corporation Code nor any other provision of the law automatically validates such transactions simply because there has been a disclosure and approval by the majority of the stockholders. That section does not operate to limit the fiduciary duties owed by a director to all the stockholders, nor does it operate to condone acts which, without the existence of a common directorate, would not be countenanced. That section does not permit an officer or director, by an abuse of his power, to obtain an unfair advantage or profit for himself at the expense of the corporation."[309] There can be little doubt that Section 713 will receive a similar construction from the New York courts.

Paragraph (*c*) of Section 713 marks a signal departure from existing case law in New York affecting the right of the board to fix the compensation of directors. The Court of Appeals has held that in the absence of some provision of statute, by-law, or charter, directors have no authority to vote salaries to themselves as a mere incident of their office.[310] The legal predicate for this position is the fiduciary role in which the directors are cast in respect to the corporation which interdicts their dealing with corporate funds for their personal benefit, at least where not sanctioned to do so—a facet of the "conflict of interest" doctrine.[311] It is the general rule under existing

307. 109 Cal. App. 2d 405, 241 P.2d 66 (1952).
308. 120 Cal. App. 2d 157, 260 P.2d 823 (1953).
309. Id. at 170, 171, 260 P.2d at 831.
310. See Godley v. Crandall & Godley Co., 212 N.Y. 121, 105 N.E. 818 (1914).
311. Butts v. Wood, supra note 300a; Carr v. Kimball, 153 App. Div. 825, 139 N.Y. Supp. 253 (1st Dep't 1912), aff'd, 215 N.Y. 634, 109 N.E. 1068 (1915).

law that a director, assuming office without any agreement as to compensation, is presumed to have undertaken to perform the duties of his office gratuitously;[312] but this assumption is not applicable where the director is requested to perform duties that are atypical to directorship and outside the customary routine of that office.[313] In such case, a contract for compensation will be implied and the board may with impunity vote compensation to the director performing unusual work, although no authority may exist generally for compensating directors. While it would seem that the board, not authorized to vote compensation to its members, should not be permitted to achieve this result indirectly by voting salaries to directors in their capacity as *officers* of the corporation under the board's conceded authority to select officers and fix their compensation (and this appears to be the import of the older cases),[314] recent cases appear to have relaxed this rule (in the trend away from the rigidity of the *Munson* case discussed above); they have held that voting such compensation to members of the board in their capacity as officers is neither void nor voidable as such but rather requires careful scrutiny—and would be voidable only if made in bad faith or fraudulently.[315]

Much of the foregoing case law would appear to have been superseded and rendered obsolete by the provision in paragraph (c) which declares flatly that "unless otherwise provided in the certificate of incorporation or the by-laws, the board shall have authority to fix the compensation of directors for services in any capacity." Questions as to the extent to which existing case law remains controlling may still arise where the certificate of incorporation or the by-laws state generally that the board shall have no power to fix the directors' compensation. Will a contract for compensation be impliable in such case for unusual services performed by a director, or will the board be competent to compensate directors for services performed as corporate officers? Although paragraph (c) is included in the section dealing with the subject of "interested directors" for obvious reasons, *it is not intended that the authority of the board to fix the compensation of directors shall be subject to the provisions of paragraph (a) dealing specially with the voidability of interested director contracts or transactions, or with the quorum provision of paragraph (b)* (although it is to be assumed that the director whose salary is being considered at a directors' meeting may be counted toward a quorum and be able to vote on the question). Compensation transactions, which, of course, involve a possible conflict of interest, are in a sense *sui generis* because each director is similarly interested and the interest is in every case known to the board. Thus, application of the disclosure provisions in paragraph (a) in such case would be patently incongruous, and to require the director to

312. Bagley v. Carthage, 165 N.Y. 179, 58 N.E. 895 (1900).
313. Fox v. Arctic Placer Mining & Milling Co., 229 N.Y. 124, 128 N.E. 154 (1920).
314. Godley v. Crandall & Godley Co., supra note 310.
315. Garbarino v. Utica Uniform Co., supra note 294; Martin Foundation, Inc. v. Phillips-Jones Corp., supra note 294.

abstain from voting on his own compensation would constitute an affectation of virtue bordering on hypocrisy. The plethora of litigation on the subject and the "juicy" cases that have resulted therefrom make it almost too trite to observe that adequate remedies are available against directors who vote themselves excessive compensation, whether in the form of salaries, bonuses, options or the like. In sum, the legislature in enacting paragraph (c) has given evidence of its faith in the essential integrity of the average board, and of its understanding that competition for talented managers is so keen in the current corporate market that boards of domestic corporations must have the necessary flexibility to compete successfully.

It is perhaps appropriate in closing this area of discussion to mention Section 714 of the Business Corporation Law which provides that loans *to* directors by the corporation may be validated only by vote of the shareholders. The shares of the director to whom the loan is made are not "shares entitled to vote" (which, as indicated in the discussion of Section 713, precludes counting the borrowing director's shares toward a quorum at the shareholders' meeting for the approval of the loan and deprives the interested director of his franchise). If the shareholder authorization requirement is not met, the transaction is not void, but the directors guilty of the violation are made responsible for this breach of duty by the express provision of *subparagraph (a) (4) of Section 719*, to the extent and under the terms set forth in such section. The foregoing provision modifies the common law rule in this state which imposed no limitations on the authority of the board to make loans to directors other than to surcharge the directors approving such a loan for any impropriety in its making. The board would, under existing law, have to justify the loan transaction as a proper exercise of its *implied* powers. It will, under the formulation in Section 714, obtain some security in the transaction through the requisite majority shareholder approval.

B. *Indemnification of directors*

The current New York statutory scheme for indemnification of directors, officers and employees, first enacted in 1941 in reaction to the now celebrated case of *New York Dock Co. v. McCollom*,[316] developed under the 1945 amendments into perhaps the most comprehensive and detailed treatment of the subject anywhere in the country. The common law backdrop against which these statutes were set reveals a number of relatively unsettled areas which, as the ensuing discussion will indicate, are not resolved but rather accentuated by the present provisions for indemnification. The *McCollom* case was decided in the context of an action brought by the corporation to have the court declare that it was not obliged to indemnify certain of its directors for expenses incurred by them in a successful defense of a derivative suit. The court declared that the corporation was under no

316. 173 Misc. 106, 16 N.Y.S.2d 844 (Sup. Ct. 1939).

common law *obligation* in such case to indemnify its directors on the ground that the possibility of such suit was a risk undertaken as a necessary incident of directorship, and that there was no showing of a benefit to the corporation in the successful defense of the suit. The absence of a common law obligation to indemnify was affirmed without opinion by the Court of Appeals in *Bailey v. Bush*,[317] and commented on with apparent approval by Judge Desmond in his opinion in *Schwartz v. General Aniline & Film Corp.*[318] The highly important question of whether a corporation is authorized, in the absence of a statute, to *voluntarily* indemnify its directors for expenses incurred in the (successful or unsuccessful) defense of an action brought against them as directors has never been satisfactorily settled, although the weight of judicial authority would appear to support such voluntary indemnification by the corporation as a common law right.[319] The only case that would appear to have grappled with this question squarely is *Simon v. Socony-Vacuum Oil Co.*[320] in which a derivative action was brought against directors who had *voluntarily* paid the fines of two (defendant) directors on their plea of *nolo contendere* when sued under the Sherman Anti-Trust Act, and had used corporate funds to defray their own expenses incurred in the defense of such prosecution. The court supported these payments (in the nature of voluntary indemnification) on the ground that the defense of the Sherman Anti-Trust Act prosecution sufficiently involved the interests of the corporation to warrant the employment of counsel to defend it, and that the payment of the (defendant) directors' fines entailed a clear benefit to the corporation. The *Socony-Vacuum* case was cited with apparent approval by Judge Fuld in *Schwartz v. General Aniline & Film Corp.* Moreover, the late Justice Carswell, who cast the deciding vote in the *Schwartz* case, suggested that Section 63 of the General Corporation Law, authorizing indemnification by certificate of incorporation provision, by-law or resolution, was a ". . . regulation of the common-law right of freedom of contract and is *merely declaratory thereof*." (Emphasis added.)

(a) *Exclusivity of Statutory Provisions*

The foregoing discussion is intended as background material for proper consideration of *Section 721* of the Business Corporation Law which in terms makes the provisions of Article 7 for indemnifying directors and officers

317. 293 N.Y. 735, 56 N.E.2d 739 (1944).
318. 305 N.Y. 395, 113 N.E.2d 533 (1953).
319. The common law right of the corporation to voluntarily indemnify is not too clear. In support thereof are such cases as: Simon v. Socony-Vacuum Oil Co., 179 Misc. 202, 38 N.Y.S.2d 270 (Sup. Ct. 1942), aff'd, 267 App. Div. 890, 47 N.Y.S.2d 589 (1st Dep't 1944); by passing suggestion, Bailey v. Bush Terminal Co., 46 N.Y.S.2d 877 (Sup. Ct. 1943), aff'd, 267 App. Div. 899, 48 N.Y.S.2d 324 (1st Dep't 1944), aff'd, 293 N.Y. 735, 56 N.E.2d 739 (1944). See, too, the opinion of Justice Carswell in Schwartz v. General Aniline & Film Corp., supra note 318. See generally, Jervis, Corporate Agreements to Pay Directors' Expenses in Stockholders' Suits, 40 Colum. L. Rev. 1192 (1940). Contra, New York Dry Dock v. McCollum, supra note 316.
320. Supra note 319.

exclusive of any other right the director or officer may have acquired by contract or otherwise from the corporation. The section provides that no right to indemnification the director may have acquired "shall be valid unless consistent with this article." This provision is, of course, designed to override the *non-exclusivity* provision found in Section 63 of the General Corporation Law to the effect that "such right of indemnification shall not be deemed exclusive of any other rights to which such director, officer or employee may be entitled *apart from this statute*." (Emphasis added.) (It is interesting to note in passing that a precisely worded non-exclusivity provision in the Model Act was eliminated therefrom in the 1959 amendments of the Act.) The vice inherent in the current non-exclusivity provision is that it authorizes (or tolerates) the loosest kind of corporate indemnification policy—*even payment of indemnification to derelict directors found to have violated the standard of conduct embodied in Section 63* ("except in relation to matters as to which it shall be adjudged . . . that such officer, director or employee is liable for negligence or misconduct in the performance of his duties") to the manifest detriment of, at least, the minority shareholders. For, if a common law right to voluntarily indemnify exists, what prevents the corporation from freely contracting with a director that he shall be entitled to indemnification in any case, despite a judicial determination that he has been guilty of negligence or some other misconduct, or from purchasing insurance with corporate funds to provide for such indemnification even where the director is adjudged guilty of wilfull misconduct? After all, the right to be indemnified in such case would be acquired by the director "apart from the statute," and *whether the non-exclusivity clause in Section 63 is qualified by the standard of conduct embodied therein has, oddly enough, never been adjudicated.* Does all this seem outlandish? In 1942, Bates and Zuckert published a highly illuminating report in the Harvard Business Review[321] on a study they had made of 169 resolutions and amendments to by-laws and certificates of incorporation proposed to shareholders during the period between 1938 and 1941 (the bulk of them in 1941) for the indemnification of directors. One hundred corporations were involved in these proposals, 98 of which had securities listed on national exchanges; 96 solicited proxies and used a proxy statement; and at least 90 were companies with national reputations. The report underscored the inadvisability of perpetuating an "open" or non-exclusive system of indemnification. It revealed an excessive amount of irresponsibility in corporate management and a consequent need to tighten the strictures on management's freedom to indemnify. The authors commented as follows:

> What finally, may seem startling to those who have not studied the resolutions closely, is that a very great many, *if not an overwhelming majority of them,* may be intended to give indemnity in suits which

321. Bates and Zuckert, Directors' Indemnity: Corporate Policy or Public Policy, 20 Harv. Bus. Rev. 244 (1942).

> are not successfully defended. If this were not the case, it would be difficult to explain the standard established for denying indemnity (such, to take one extreme case, for example, as providing indemnity against all liabilities to which subject, explicitly whether or not negligent, except when caused by wilfull misconduct). And some proposals explicitly purport to give indemnity for "judgment" and "money damages." . . . If the proposals are carefully examined to see what management apparently wants by way of indemnity, what shall we conclude? *Extensions of the scope of these agreements removes much of the ring of truth from the original cry that managements seek only protection from "unfounded suits."* It must be inferred that managers are attempting to escape responsibilities attaching to their offices, or accepting their frequently announced disclaimer that such is not their purpose, that they are trying to establish new standards and procedure —perhaps a "law corporate"—to supplant substantive law with which they are not in agreement and a judicial process in which they have no confidence that justice will be done. How else can one explain the ultimate provisions for reimbursement even when judgments have been obtained against directors and officers.[322] (Emphasis added.)

The statutory provisions for indemnification, adopted in 1941 and thereafter amended, have not served to ameliorate in any appreciable way the serious conditions exposed in the Bates and Zuckert report—because of the non-exclusivity clause incorporated in the original indemnification section, 27-a of the General Corporation Law and perpetuated in its successor, Section 63. Corporations have relied strongly on this clause to justify reimbursing directors and officers in some rather questionable cases, such as, for expenses incurred and amounts paid in defending and settling *threatened* derivative suits (never actually commenced), for amounts paid (as contrasted with expenses incurred) in settlement of pending derivative suits without court approval, and the like. No doubt the practice continues in some corporations of assuring reimbursement, by prior contract, to directors and officers against whom judgment is obtained for their negligence or other misconduct. The extent to which this practice continues is surely difficult to estimate, although no reason is perceived why corporations would have discontinued such practice in light of the non-exclusivity clause in the present statute. It is anticipated that Section 721 of the new law will tend to eliminate such improprieties. A statutory provision (such as the current non-exclusivity clause) that admits of the possibility of broader indemnification than it is thought necessary to affirmatively sanction by statutory standard is both anomolous and dangerous. The adoption of an exclusive system of indemnification that restricts corporations to a prescribed standard is surely salutary, and should occasion no hardship to corporations in this state in view of the explicit provision made for indemnification in non-derivative suits against directors and officers. As further discussion will amplify, directors and officers subjected to any suit in such capacity, whether civil or

322. Id. at 256, 258.

criminal, will be reimbursable for litigation and other expenses, including attorneys' fees (and, in the case of the defense of non-derivative suits, for the amount of a judgment or fine suffered by them, or amounts paid in settlement) either by court award or voluntary corporate action, in relation to matters as to which they have not been adjudged to have breached the prescribed standard of conduct. No reasonable director should in good conscience expect more.

(b) *Kind of Action or Proceeding in Which Indemnification is Authorized; Standards of Conduct Prescribed*

The present statutes do not carefully delineate the types of actions or proceedings in which indemnification is authorized. The failure to clarify this area was perhaps the crucial factor in the denial of indemnification in *In re Schwartz v. General Aniline & Film Corp.*[323] to plaintiff-director who had been prosecuted criminally for violation of the Sherman Anti-Trust Act and had pleaded *nolo contendere.* Judge Desmond held squarely that the draftsmen of Article 6-A (Sections 63-68 of the General Corporation Law) had contemplated only the traditional derivative action in framing the indemnification legislation —on the basis of the contextual juxtaposition of these (indemnification) sections to other sections of the law related to derivative actions, and because these sections were legislated into existence in 1945 along with the "contemporaneous ownership" amendment to Section 61 of the General Corporation Law and the famous "security for expenses" statute, Section 61-b of the General Corporation Law (both enactments being clearly geared to the derivative suit). Justice Carswell's decisive opinion in the *Schwartz* case was premised on a construction of (the procedural) Section 65 which demonstrated that the legislature could not have contemplated reimbursing directors for the defense of criminal prosecutions. Moreover, the present statutes do not clarify indemnification rights in a large category of suits, brought by third persons against corporate directors and officers in their capacity as "agents" of the corporation, that do not fall into the derivative action mold, in the defense of which the defendant director or officer may be required to expend large sums of money. Professor Bishop, in an elucidative article in the Harvard Law Review,[324] emphasizes that the common law entitled an agent to be reimbursed by his principal for costs and expenses incurred when acting within the course of his employment and for the best interests of his principal. He argues eloquently that this principle should apply to corporate personnel when sued, not by the corporation, directly or indirectly, for breach of a duty to it, but by a third party for the consequences of acts done as a director, officer (or employee) of the corporation in the honest belief that he is acting in the best interests of the corporation.

The new law authorizes indemnification of directors and officers in both

323. Supra note 318.
324. Bishop, Current Status of Corporate Directors' Right to Indemnification, 69 Harv. L. Rev. 1057 (1956).

derivative (*Section 722*) and non-derivative (*Section 723*) categories.[325] Although Section 722 is the almost verbatim counterpart (with the non-exclusivity clause omitted) of the present Section 63 of the General Corporation Law, an important difference should be noted in the way the prescribed standard of conduct is stated. The standard is described in the new law as "breached (his) duty to the corporation under section 717" as contrasted with "is liable for negligence or misconduct in the performance of his duties" in the present law. The more generic statement of the standard in the new law, adopted by the Model Act in its 1959 amendments, would seem more appropriate to the essential character of the derivative suit, and has the added advantage of conforming the standard of conduct for indemnification to the definition of the directors' duty to the corporation spelled out with some particularity in Section 717. Section 723 is a new formulation for this state. It affords indemnification rights to directors and officers charged in non-derivative actions or proceedings with tortious or criminal conduct, breach of contract, or the like that has resulted from activity in the course of employment, undertaken for the benefit of the corporation. Such suit may have resulted in a judgment or verdict against the director or officer who, nonetheless, may have conducted himself in the good faith belief that he was acting properly in the best interests of the corporation (and may, indeed, have been encouraged in that view by corporate management as a whole). Included in such category of non-derivative actions or proceedings may be suits brought to enforce criminal sanctions imposed by federal acts, such as the Sherman Anti-Trust Act and the various Federal Securities Acts, as well as similar state civil and penal laws. The sanctioned conduct may well have represented the implementation of a fixed corporate policy, and the defendant director or officer may have been advised by (eminent) corporate counsel that his activity was perfectly legal. It is difficult to comprehend why the often enormous expenses of litigation incurred (and judgmenst or fines suffered) in the defense of such suits and, in a sense, in defense and vindication of corporate policy should not be reimbursable. Accordingly, Section 723 overrules *Schwartz v. General Aniline & Film Corp.* by expressly providing that directors and officers may be indemnified for the defense of a criminal action or proceeding. The section would likewise authorize corporate reimbursement of expenses incurred by a director or officer who may have been summoned to appear before investigating or examining public bodies relative to activities in behalf of the corporation, although such proceedings may not involve a determination of civil or criminal liability.[325a]

The standard of conduct prescribed to qualify a director or officer for

325. The indemnification provisions of the (1961) Business Corporation Law have been reorganized without any substantive change pursuant to an amendment which was approved at the 1962 session of the New York Legislature. The effect of this "regrouping" of materials will be reflected hereafter in the appropriate footnotes.

325a. Note, Essential Enterprises Corp. v. Automatic Steel Products, Inc., — Del. Ch. —, 164 A.2d 437 (1960) where indemnification was allowed for defense of status as a director.

indemnification in non-derivative suits has been tailored to the realities of such suits. The issue in such suits not being whether the director has breached his duty to the corporation (as it is in derivative suits), the "duty to the corporation" standard employed in section 722 to qualify for indemnification in derivative suits is not strictly appropriate. Rather, the question is whether, in acting as he did, the director or officer pursued his responsibilities in the good faith *belief* that he was accommodating the best interests of the corporation (*i.e.*, performing his duty to the corporation), although it might eventuate that what he had done was not in fact in the best interests of the corporation and, indeed, may have caused it injury. Thus, in implementing corporate policy, a director or officer may have acted negligently or otherwise improperly and thereby exposed himself and his corporation to liability under a federal securities act, the Sherman Anti-Trust Act or a state's blue-sky laws, and yet qualify for indemnification because he has, in the language of Section 723, "acted, in good faith, for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal actions or proceedings, in addition, had no reasonable cause to believe that his conduct was unlawful . . . ."

(c) *Degree of Success Required For Reimbursement*

It is too obvious to require belaboring that where a director or officer has successfully defended an action or proceeding against him on the merits, after full litigation of the issues, he should be entitled to indemnification as a matter of right, unless a corporate policy against indemnification (expressed in certificate of incorporation provision, by-law, resolution contract, or by other proper corporate action) was in effect and binding on the director or officer at the time of the accrual of the cause of action or proceeding brought against him. This is the clear import of *paragraph (a) of Section 725*[326] of the Business Corporation Law. Conversely, if such director or officer has been adjudged fully liable *on all counts* for breach of duty to his corporation in a derivative suit, or is found to have violated the prescribed standard of conduct in his activities resulting in a non-derivative suit brought against him, reimbursement of litigation costs and expenses is clearly not warranted and so the courts have held.[327] There are, however, a number of situations, intermediate the foregoing extremes, in which either full liability on all counts is not adjudged in the action or proceeding, or a successful defense is available on some technical ground (not on the merits), or the suit is terminated by settlement—which present perplexing questions as to the right of the director or officer to indemnification in the particular case. Typical of these situations are the following: (1) liability of defendant is adjudged on each count of the complaint but for less than the relief demanded; (2) liability of defendant is adjudged on one

326. This is now N.Y. Bus. Corp. Law § 724(a).

327. See Apfel v. Auditore, 223 App. Div. 457, 228 N.Y. Supp. 489 (1st Dep't 1928), aff'd, 250 N.Y. 600, 166 N.E. 339 (1929). See Washington, Litigation Expenses of Directors in Stockholders' Suits, 40 Colum. L. Rev. 431, 433 (1940).

or more, but less than all, counts of the complaint; (3) liability is not adjudged to exist on the ground that the statute of limitations has expired, or plaintiff has failed to post security for expenses, or plaintiff has participated in the wrong of which he complains and is foreclosed in equity from proceeding with the suit, or the suit has lapsed or been discontinued by plaintiff without settlement: (4) although defendant has been adjudged fully liable, his defense has resulted in a tangible benefit to the corporation; (5) there has been a settlement or compromise with or without court approval.

In appraising the right of directors and officers to be indemnified in certain of the above enumerated situations, New York courts have reached variant results in implementing their power to indemnify under present Sections 64 and 67 of the General Corporation Law, the latter section authorizing the court to indemnify upon a finding that "the applicant, his testator or intestate was successful in whole or in part, or that the action against him has been settled with the approval of the court. . . ." Thus, in *Tichner v. Andrews*,[328] indemnification was awarded where the action was dismissed for failure of plaintiff to provide security for expenses under Section 61-b of the General Corporation Law; and, similarly, in *Dorman v. Humphrey*,[329] indemnification was allowed where the complaint had been dismissed because the statute of limitations had expired, the court indicating that to recover indemnification the defendant need not be exonerated on the merits of charges of misconduct but only be free of an *adjudication* of misconduct. *Courts will, under the new law, be required to reach the same result in the foregoing cases by virtue of paragraph (a) of Section 725*[330] which provides ". . . a director or officer who has been wholly successful, on the merits *or otherwise*, in the defense of a civil or criminal action or proceeding shall be *entitled* to indemnification . . . ." (Emphasis added.) The phrase "or otherwise" is designed to cover cases, like *Tichner* and *Dornan*, where defendant has been wholly successful by reason of a technical defense to a suit. There is really no escape from this result, for, otherwise, the court, permitted to pursue the investigation of defendant's guilt, would be authorized to discredit a valid defense provided by law. Question may arise as to the extent to which *Diamond v. Diamond*[331] will retain vitality as a precedent and serve to qualify the apparently conclusive language of paragraph (a) set forth above. In the *Diamond* case, a derivative action was dismissed upon a finding that plaintiff had participated in the wrong of which she complained. An award of indemnification, made by the court because there had been no adjudication of misconduct and defendant had been wholly successful in her defense, was reversed by the Court of Appeals on the ground that

328. 193 Misc. 1050, 85 N.Y.S.2d 760 (Sup. Ct. 1949), appeal dismissed, 275 App. Div. 749, 90 N.Y.S.2d 920 (1st Dep't 1949).
329. 278 App. Div. 1010, 106 N.Y.S.2d 142 (4th Dep't 1951). See also Austrian v. Williams, 120 F. Supp. 900 (S.D.N.Y. 1953).
330. Supra note 326.
331. 307 N.Y. 263, 120 N.E.2d 819 (1954).

there was evidence in the findings below of defendant's complicity in the secret withdrawal of corporate funds (ostensibly to defraud the government of corporate and personal income taxes). The Court stated that "[but] 'adjudged' is not so completely a word of art or of such technical meaning . . . that we cannot seek out the obvious legislative intent. Section 64, changing the common-law rule that each party pays his own lawyer, is to be construed strictly. See, Schwartz v. General Aniline & Film Corp. . . . *Rewarding faithless officers and directors was no part of its purpose.* In all reason and common sense, this defendant has been, in the affirmed findings below, 'adjudged . . . liable for . . . misconduct in the performance of his [her] duties'."[332] (Emphasis added.) The rule of the *Diamond* case has recently been followed by the Appellate Division, Fourth Department in the interesting case of *People v. Uran Mining Corporation*[333] which involved a suit under the Martin Act to enjoin the corporation and others (including one Colby) from continuing certain fraudulent securities practices. The complaint was dismissed on the merits as to Colby but the court denied his application for payment of his expenses in defending the suit on the ground that Colby had not been made a party defendant by reason of his having been a director or officer of defendant corporation (as required by the express language of Section 64 of the General Corporation Law). The merits of the application were not otherwise considered. The Appellate Division, disagreeing with the reasons, affirmed the result below. Finding that Colby had been made a party to the suit in his capacity as director and officer of Uran, and that the People's action under the Martin Act was civil in nature (so that *Schwartz v. General Aniline & Film Corp. was not controlling*), the court applied the doctrine of the *Diamond* case to the effect that the legislature in enacting Section 64 did not intend to reward faithless officers and directors, and held that "proof of applicant's good faith is a basic requirement. This proof is completely lacking. Indeed, the record clearly compels an opposite conclusion." There is every reason to believe that the courts will continue to adopt this fundamentally equitable approach to indemnification under the new law. Nothing in Article 7 interdicts it.

Other cases reflect variant judicial attitudes, in the exercise of the discretion to indemnify, where there has not been complete vindication of the director or officer on the merits. In *Cachules v. 116 East 57th Street*,[334] without referring to Section 64, the court disallowed indemnification on the ground that although defendant had succeeded in clearing himself of some of the charges in the complaint, the net result was a judgment in favor of the corporation against him. In *Cohn v. Columbia Pictures Corp.*,[335] the complaint alleged that defendant directors had made an improvident contract with a fellow director, Cohn, and had employed and paid counsel to represent Cohn

332. Id. at 267, 120 N.E.2d at 821.
333. 13 A.D.2d 419, 216 N.Y.S.2d 985 (4th Dep't 1961).
334. 127 N.Y.S.2d 795, 799 (Sup. Ct. 1953).
335. 117 N.Y.S.2d 809 (Sup. Ct. 1952).

in negotiating the contract. Cohn (who had apparently not been served with process in the action) offered a compromise which was approved by the court. The court allowed the defendant directors indemnification, stating that "Section 64 of the General Corporation Law provides and authorizes reimbursement and compensation and no reason manifests itself why the *successful* defendants should not have the benefit of this enactment."[336] (Emphasis added.) It will be noted that the settlement in this case resulted in a judgment in favor of plaintiffs. In *Marco v. Sachs*,[337] the court, citing *Tichner v. Andrews*,[338] asserted in dictum that a vindication on the merits is not a necessary precondition for an assessment of costs and expenses against the corporation under Section 64.

The circumstance that the corporation has received a benefit as a result of the defendant director's conduct of the defense in the derivative action has been seized on as the basis for assessing the costs and expenses of the litigation against the corporation. In *Godley v. Crandall & Godley Co.*,[339] action was brought against the directors to compel them to disgorge misappropriated funds and for the appointment of a receiver of all the assets of the corporation (also made a party defendant). The defendant directors used corporate funds to pay their own litigation expenses in the action. The directors were held liable in a substantial amount, but the receivership was denied. In a subsequent suit to recover from the directors the corporate funds used to defray their expenses in the previous suit, the use of such funds was upheld and the directors exonerated because the corporation had received a benefit in having avoided a receivership. In *Albrecht, Maguire & Company v. General Plastics, Inc.*,[340] a similar "benefit" theory was indulged to support the assessment of litigation expenses against the corporation. A minority shareholder had brought suit to enjoin a threatened violation of his preemptive rights by a new stock issue. An injunction was granted, but the attempt to charge defendant directors with the entire cost of the litigation was thwarted. The court held that the individual directors had acted in good faith, the corporation was a necessary party, and the interests of the corporation were sufficiently concerned to warrant the employment of counsel to defend the suit in its behalf. Note, likewise, in this context, *Simon v. Socony-Vacuum Oil Co.*,[341] where the court's decision rested in part on the circumstance that in pleading *nolo contendere* defendant-directors had conferred a benefit upon the corporation. The court

336. Id. at 814.

337. 201 Misc. 928, 932, 106 N.Y.S.2d 522, 527 (Sup. Ct. 1951), aff'd, 279 App. Div. 1085, 113 N.Y.S.2d 449 (2d Dep't 1952), aff'd, 304 N.Y. 912, 110 N.E.2d 737 (1953).

338. Supra note 328.

339. 153 App. Div. 697, 139 N.Y. Supp. 236 (1st Dep't 1912), modified 212 N.Y. 121, 105 N.E. 818 (1914); 181 App. Div. 75, 168 N.Y. Supp. 251 (1st Dep't 1917), aff'd, 227 N.Y. 656, 126 N.E. 908 (1920).

340. 256 App. Div. 134, 9 N.Y.S.2d 415 (4th Dep't 1939), aff'd, 280 N.Y. 840, 21 N.E.2d 887 (1939).

341. Supra note 319. See also Warnecke v. Forty Wall Street Bldg., Inc., 16 Misc. 2d 467, 183 N.Y.S.2d 925 (Sup. Ct. 1959); Heller v. Boylan, 29 N.Y.S.2d 653, 696 (Sup. Ct. 1941); Kirby v. Schenck, 25 N.Y.S.2d 431 (Sup. Ct. 1941).

held, citing *Godley* and *General Plastics, Inc.* as supporting precedents, that the directors were not chargeable with the litigation expenses of the defense although it was unsuccessful.

The foregoing, somewhat detailed, recital of judicial precedent has been undertaken because it is expected that these authorities will retain some vitality under the new law. Under *Section 724*[342] of the Business Corporation Law, courts are vested with power to award indemnification *to the extent authorized in Sections 722 and 723*—and even where the corporation has failed to make provision for, or *refused* in a specific case to authorize, such indemnification. Under this formulation, since corporations are authorized under Sections 722 and 723 to indemnify in cases where the director or officer has not been wholly successful, on the merits or otherwise, in the defense of the suit or where the suit has been settled or compromised, courts are vested with similar authority. Sections 722 and 723 retain the formula found in the present statutes that indemnification may be made "*except in relation to matters*" (Emphasis added.) as to which the director or officer has been adjudged to have breached the prescribed standard of conduct. Hence, indemnification *may* be made by the corporation and awarded by the court *in relation to matters* as to which the director or officer has not been adjudged to have violated the prescribed standard. This authorization would encompass settlements as well as adjudicated cases in which the director or officer has been (partially) successful in defeating some, but not all, counts of the complaint. Cases in which the defendant has lost on all counts, but the damages are appreciably lower than the relief demanded, or an incidental benefit has been conferred on the corporation, do not readily qualify for indemnification under the foregoing formula—although precedents such as the *Godley, General Plastics* and *Socony-Vacuum Oil Co.* cases discussed above provide evidence that the existing formula has been stretched by the courts to encompass even such cases.

(d) *Policy Considerations Affecting Indemnification Under the New Law*

Derivative suits: As the Bates and Zuckert report reveals, some corporations make provision for reimbursement of directors and officers extensive enough to include expenses incurred and amounts paid in the settlement of claims and *threatened* derivative suits, and amounts paid in settling pending derivative suits with or without court approval. The authors had this comment to make about the practice of reimbursing the cost of defending and settling threatened suits:

> The second class of situations referred to is that involving claims and threatened suits in which actual legal steps are never initiated. A suit that is never more than threatened can reasonably result in very little expense and therefore cannot be the thing over which directors are really worried; and it is too nebulous a thing around which to erect

342. Now N.Y. Bus. Corp. Law § 725 (see supra note 325).

> safeguards and standards. In many instances, moreover, the corporation itself would be under the threat of being made a party to the suit or would be contingently liable on its indemnity if the suit were instituted and successfully defended, so that if the threat were taken seriously, it could be the normal concern of company counsel on behalf of the company to examine the claims asserted.[343]

There would appear to be little room for argument with the conclusion drawn by the authors that the gossamer line between the threat to institute a derivative suit and its actual commencement by mere service of a complaint is too slender a reed upon which to construct adequate controls and safeguards against impropriety. On balance, the policy position reflected in *subparagraph (f) (1) of Section 725*[344] disallowing reimbursement of expenses incurred in defending or amounts paid in settling threatened derivative suits would seem quite correct. It must be kept in clear perspective that what is here involved is a threatened suit premised on the faithlessness of the very directors and officers who, were a different position taken, would be empowered to divert the suit through the use of corporate funds. The argument, sometimes made, that the corporation can, at the threat stage, forestall at small cost the commencement of unfounded suits which, if instituted, might involve it in substantial expense is not readily subject to verification. On the other hand, authorization to indemnify in such case would make available a too facile mechanism for avoiding the most prohylactic remedy against unfounded derivative suits—the doctrine of *Clark v. Greenberg*[345]—that any recovery by plaintiff-shareholder in a derivative suit belongs to the corporation. This doctrine, codified in *paragraph (e) of Section 626* of the Business Corporation Law, likewise illuminates the provision embodied in *subparagraph (f) (2)* of Section 725[346] that amounts paid (as contrasted with expenses incurred) in the settlement of pending derivative suits with court approval cannot be reimbursed. Since plaintiff-shareholder must account to the corporation for any recovery in the derivative suit, it would seem altogether incongruous to authorize the amount paid in settlement of the suit by the *presumably* derelict director to be returned to him by way of reimbursement. In similar vein, *subparagraph (f) (3)* of Section 825,[346a] precluding any reimbursement for the expenses and costs of defending pending derivative suits settled *without court approval* is consistent with (and in aid of) the fundamental policy embodied in *paragraph (d) of Section 626* of interdicting the noxious practice (to the extent that it remains) of settling derivative suits without court approval.

Non-derivative suits: The same considerations that prompted a rather restrictive indemnification policy in derivative suits do not legitimately apply

343. Supra note 321 at 260.
344. Now N.Y. Bus. Corp. Law § 722(a) (see supra note 325).
345. 296 N.Y. 146, 71 N.E.2d 443 (1947).
346. Now N.Y. Bus. Corp. Law § 722(b)(1).
346a. Now N.Y. Bus. Corp. Law § 722.

to non-derivative suits brought against directors and officers. The legal predicate of such suits is not the defendant's breach of duty to the corporation. It is rather the violation of some *duty owed to the plaintiff*, whether he be a contractee with the corporation whose rights have been disturbed by defendant officer or director, a person injured by defendant's negligent operation of a company vehicle, or the state or federal government alleging some infraction of its laws. In such cases, the defendant-director or officer is cast essentially in the role of an "agent," and if he can establish that he has met the prescribed standard of conduct (*i.e.*, has acted in good faith for a purpose which he reasonably believed to be in the best interests of the corporation and, in criminal proceedings, had no reasonable cause to believe his conduct was unlawful), the director or officer should be entitled to reimbursement for expenses incurred and amounts paid (by way of judgments, fines, or settlements) in defending either threatened or pending suits of the non-derivative variety. The policy factors that militate against authorizing indemnification of threatened derivative suits (where the complaint alleges defendant's breach of duty to the corporation) are patently inapplicable in non-derivative suits (where the complaint alleges improprieties committed by defendant *on behalf of* the corporation and ostensibly in its interest).

In general: A number of policy considerations that apply generically to indemnification in derivative and non-derivative suits alike, and whether indemnification is made by voluntary corporate action or by court award, should be noted.

(a) The new law expressly authorizes the corporation to pay to directors and officers the expenses of litigation *in advance of its final disposition* (*paragraph* (*b*) of Section 725)[347] and the court to award such litigation expenses pendente lite (*paragraph* (*c*) of Section 725).[348] These provisions constitute statutory recognition of a practice fairly common among corporations in this state. In light of the often burdensome expenses of such litigation, they would, on balance, seem desirable policy expedients because of their tendency to encourage the assumption of stewardship responsibilities in domestic corporations. It should be noted that under *paragraph* (*d*) of Section 725,[349] such advance payments of litigation expenses must be repaid by the director or officer in the event he is ultimately found not to be entitled to indemnification, or, where indemnification is granted, to the extent the expenses allowed by the corporation or awarded by the court exceed the indemnification to which he is entitled.

(b) Unless the director or officer is wholly vindicated on the merits or otherwise, no indemnification may be made by the corporation for the defense of either a derivative or a non-derivative suit except upon a *post hoc* finding, by a quorum of disinterested directors, or in the absence thereof, by either the

347. Now N.Y. Bus. Corp. Law § 724 (c).
348. This provision, oddly enough, remains § 725(c) under the regrouping.
349. Now N.Y. Bus. Corp. Law § 726(a).

board upon written opinion of independent legal counsel or by the body of shareholders, that the director or officer has *in the specific case* met the presribed standard of conduct. (Similar approval is required for pre-payment of litigation expenses by the corporation.) The purpose of these provisions is to require a determination of entitlement in each case *after the event* so as to identify the corporate group that assumes responsibility for such determination, and to eliminate the practice of absolutely binding the corporation by agreement with the director or officer before the event. Under a proposed amendment to *subparagraph (a) (10) of Section 202*,[350] the corporation will have the general power to indemnify corporate personnel, but any contract to indemnify a director or officer entered into prior to the litigation in which expenses and costs are incurred will necessarily be subject to all provisions of Article 7 affecting indemnification, including the requirement of board or shareholder approval *after the event*. However, the director or officer, entitled to reimbursement, who is improperly denied payment by a hostile board (that has, for example, unseated an incumbent board after a proxy fight) will have an enforceable contract right.[351]

(c) The indemnification sections of the new law omit any specific reference to the rights of corporate "employees" to indemnification, such as is found in the existing statutes. Indirect reference to the indemnification rights of such employees is found in *Section 721* which provides that "nothing contained in this article shall affect any rights to indemnification to which corporate personnel *other than directors and officers* may be entitled by contract or otherwise under law."[352] (Emphasis added.) Similarly, the proposed amendment to subparagraph (a) (10) of Section 202, referred to above, gives every domestic corporation the general power "to indemnify corporate *personnel*." (Emphasis added.) There is no doubt that the right of corporate employees to reimbursement of expenses and costs of litigation is recognized at common law in nonderivative suits. Although the courts have had little occasion to consider the right of employees to indemnification in derivative suits (the incidence of such suits against employees *as such* being very rare), there is little reason to anticipate denial by the courts of reimbursement rights to employees in such suits. On the other hand, the inclusion of "employees" within the coverage of the indemnification sections would be incompatible with the general pattern of Article 7 of the Business Corporation Law which is devoted exclusively to directors and officers. More particularly, the standard of conduct prescribed for indemnification in derivative suits is geared to the "duty to the corporation under section 717." The duty to the corporation as defined in that section would seem altogether too stringent and too "fiduciary" for proper application to ordinary corporate employees.

350. This has been approved at the 1962 session of the New York Legislature.
351. Of course, the director or officer has the statutory right in any case, despite the corporate refusal to indemnify him, to seek indemnification judicially (see (new) § 725).
352. Supra note 350.

(d) Other provisions, carried over from existing law, should be mentioned. Section 725 provides that no indemnification shall be made in any case where it appears that it would be inconsistent with the law of the home state of a foreign corporation which prohibits or otherwise limits such indemnification (*subparagraph (g) (1)*),[353] or that such indemnification would be inconsistent with any condition affecting indemnification imposed by a court in approving a settlement (*paragraph (g) (3)*).[354] *Pargaraph (h)* of Section 725[355] prescribes notice to the shareholders, within a designated period, of any indemnification that is made otherwise than by court order or action by the shareholder. Finally, *paragraph (i)* of Section 725[356] makes the indemnification provisions of Article 7 applicable to foreign corporations *doing business in this state*, except to the extent that such corporations qualify for exemption under Section 1320 of the Business Corporation Law.

IV. *Liability of Directors*

Liability in certain cases: In sharp contrast with its diffuse treatment under the existing statutes, *Section 719* of the Business Corporation Law, adopting the pattern and, in part, the content of Section 43 of the Model Act, packages very neatly all of the *specific* instances under the new law in which liability is imposed upon directors for misconduct. These are only four in number and include: (1) declarations of a dividend or other distribution of cash or property in violation of *Section 510*; (2) reacquisitions of corporate shares in violation of *Section 513*; (3) distributions of assets to shareholders, during the liquidation period after dissolution, without satisfying the claims of all known creditors; (4) loans to directors contrary to *Section 714*. It will be noted that the new law *omits* three areas of specific liability currently imposed on directors under: *Section 15 of the Stock Corporation Law*[357] (the New York "trust fund" statute which prohibits the transfer by a corporation of any of its property to officers, directors or shareholders for the payment of any debt or upon any consideration other than full value in cash or property while the corporation is insolvent in the equity sense, and preferential transfers, with intent to prefer, to creditors who receive such transfers with knowledge they were made with intent to give them a preference); *Section 59 of the Stock Corporation Law*[358] (which prohibits directors or officers from making loans to shareholders, discounting notes or other evidences of indebtedness, or

353. Now N.Y. Bus. Corp. Law § 726(b)(1).
354. Now N.Y. Bus. Corp. Law § 726(b)(3).
355. Now N.Y. Bus. Corp. Law § 726(c).
356. Now N.Y. Bus. Corp. Law § 726(d).
357. See supra note 212.
358. Criminal responsibility remains. See N.Y. Penal Law § 664(3) (director concurring in, or voting for, receipt or discount of any note or other evidence of debt in payment for shares is guilty of a misdemeanor); § 664(4) (or, with intent to do so, allows any shareholder to withdraw any part of his capital contribution, is likewise guilty of a misdemeanor).

from receiving the same in payment of an installment or any part thereof due on any shares, or from receiving or discounting any note or other evidence of indebtedness to enable a shareholder to withdraw any part of his capital contribution); *Section 61 of the Stock Corporation Law*[359] (which imposes liability upon directors and officers for issuing any certificate, report, or public notice that is false in any material misrepresentation. Liability is imposed on directors and officers who *sign* such false statements).

Under *paragraph* (*a*) of Section 719, liability is imposed on directors who vote for or concur in the foregoing corporate actions. *Paragraph* (*b*), designed to define when a director can be said to have *concurred* in any such action, creates a *presumption of concurrence* for directors *present* at a meeting at which an action specified in paragraph (a) is taken—which becomes conclusive unless a dissent from the action taken is registered at the meeting or promptly thereafter. A similar presumption affects directors *absent* from the meeting who do not record a dissent within a reasonable time after *learning* of the action taken. The absentee director would presumably be obliged to make some effort to learn of the action taken at the meeting within a reasonable time thereafter. These provisions are patently aimed at inducing active participation by directors in the deliberations of the board and an affirmative discharge by them of stewardship responsibilities. A precisely parallel provision is presently found in Section 58 of the Stock Corporation Law which exonerates a director from liability for an improper declaration of a dividend or other distribution of assets to shareholders if he has registered his dissent from the action in the minutes of the meeting or, if absent, has communicated his dissent therefrom to the corporation within a reasonable time after learning of the action. Similarly, *Section 667 of the Penal Law* imposes a "presumption of assent" on directors who do not register a formal dissent from actions taken which are made criminal under the provisions of Article 64 of the Penal Law.

Attention should be directed at this point to *paragraph* (*e*) of Section 719 which provides that a director cannot be charged with liability under the section if he is found, in the circumstances of the case, to have discharged his duty to the corporation under Section 717. It will be recalled, from a previous discussion of this subject under the heading "Directors' duty of diligence, care and skill; reliance on financial statements," that in discharging his duties as defined in Section 717 a director may rely in good faith on financial statements represented by accredited accountants and corporate fiscal officers to fairly reflect the financial condition of the corporation. A parallel provision is embodied in Section 58 of the Stock Corporation Law which exonerates directors from liability for improper dividend declarations and other distributions of as-

359. There has not been a single case litigated under this section since 1912 (when the annual report, which had to be signed by responsible corporate officers, was written off the books). It is felt that the content of this section is amply covered by N.Y. Bus. Corp. Law § 720 (currently N.Y. Gen. Corp. Law § 60), or by common law principles of liability.

sets to shareholders if they can *affirmatively* show that "they had reasonable grounds to believe, and did believe, that such dividend or distribution would not impair the capital of the corporation." Presumably, under the existing formulation, directors would sustain their burden if, acting in good faith, they relied on financial reports of accredited accountants or corporate officials. Paragraph (e) was included expressly in Section 719 (it would seem naturally impliable in any case), for the same reason that the foregoing provision was included in Section 58 of the Stock Corporation Law—to preclude, beyond peradventure, a construction of Section 719 (such as was given to the former Section 58 in cases like *Quintal v. Greenstein*)[360] that a violation of the statutory strictures creates automatic liability, without regard to good faith and the absence of negligence.

Under *paragraph* (*a*) of Section 719, the remedy for the enforcement of the joint and several liability of the directors is given *exclusively* "to the corporation for the benefit of its creditors or shareholders to the extent of any injury suffered by [them] . . ." as a result of the action taken. This important innovation was induced by the extremely confused state of existing case law as to the availability of a suit by an individual creditor to recover in his own right from derelict directors a corporate fund that rightfully belongs to all creditors and shareholders similarly injured. For example, in *Buttles v. Smith*,[361] the Court of Appeals upheld the right of an individual creditor, acting in his own behalf, to set aside transfers of corporate property made in violation of Section 15 of the Stock Corporation Law on the ground that the wrong to the creditor by such transfer is independent and distinct from the wrong to the corporate debtor. Although the reasoning in support of the result in the *Buttles* case is not altogether satisfactory (and no wrong to the corporate debtor was urged in the complaint), the principle was followed in the later case of *Menkes Feuer, Inc. v. The Peoples Bank of Johnstown*.[362] In the recent case of *Shaw v. Jewel Radio Corporation*,[363] the Appellate Division, Second Department virtually nullified the importance of these precedents by explaining that the general rule of damages, in suits under Section 15 of the Stock Corporation Law and kindred statutes, is "the amount of money which he [the plaintiff] would have received as a creditor if no preferential payments and transfers had been made *and if the subject corporation's assets had been distributed to all its creditors in proportion to the respective amounts of their just claims*."[364] (Emphasis added.) The court went on to explain that damages in the amount

360. 142 Misc. 854, 256 N.Y. Supp. 462 (Sup. Ct. 1932), aff'd, 236 App. Div. 719, 257 N.Y. Supp. 1034 (1st Dep't 1932).
361. 281 N.Y. 226, 22 N.E.2d 350 (1939).
362. 268 App. Div. 809, 48 N.Y.S.2d 593 (3d Dep't 1944), aff'd, 294 N.Y. 748, 61 N.E.2d 746 (1945).
363. 6 A.D.2d 707, 174 N.Y.S.2d 315 (2d Dep't 1958). See also, on the same point, Newfield v. Ettlinger, 22 Misc. 2d 769, 194 N.Y.S.2d 670 (Sup. Ct. 1959), appeal dismissed, 10 A.D.2d 947, 205 N.Y.S.2d 908 (1st Dep't 1960).
364. Id. at 708, 174 N.Y.S.2d at 318.

of a plaintiff's entire claim (not limited to a pro rata share) are awarded only in exceptional cases, as where "an actual levy had been made on the property in question by virtue of an execution issued in pursuance of a money judgment in favor of the plaintiff against the debtor corporation." The court might well have added that careful scrutiny of frequently cited precedents which support the proposition that an individual creditor may recover his full claim, such as *Buckley v. Stansfield*,[365] reveals that the plaintiff in these cases was the *sole* corporate creditor or, if other creditors existed, their rights were not shown to be adversely affected. In *Hastings v. H. M. Byllesby & Co.*,[366] where a trustee in bankruptcy brought an action *in behalf of creditors* for the relief provided in subdivisions 1 and 2 of Section 60 of the General Corporation Law (basically, actions sounding in negligence, conversion or waste), the Court of Appeals, distinguishing *Buttles v. Smith*[367] (where the action was grounded on Section 15 of the Stock Corporation Law and *subdivision 5* of Section 60 of the General Corporation Law which provides for an action to set aside an improper transfer of corporate property), held that actions brought under subdivisions 1 and 2 of Section 60 *belong to the corporation* and relief thereunder cannot be sought in behalf of the creditors in their individual rights. In *Rieser v. Baltimore & O.R. Co.*,[368] a federal court in the southern district of New York, understandably confused, was moved to comment that "it may be seriously questioned whether in fact the Buttles case represents a 'wrong to the creditor . . . independent and distinct from any wrong to the corporate debtor,' in contradistinction to the claim in the Hastings case which 'arises only indirectly from the damage or injury to the corporation and is repaired when the damage or injury to the corporation is repaired.' *Both claims may well have stood on the same ground so far as their derivative or independent nature is involved.* If so, then the Hastings case may not be distinguishable but *may have overruled pro tanto the Buttles case.*"[369] (Emphasis added.) The confusion is compounded when one finds that a single creditor cannot recover his full claim in a suit brought against directors for an improper dividend declaration under Section 58 of the Stock Corporation Law, but must bring a representative action in equity in behalf of all creditors similarly affected;[370] yet, as recently squarely held in *American Broadcasting-Paramount Theatres, Inc. v. Frye*,[371] a single creditor may recover his full claim against derelict directors for improper loans to shareholders in violation of Section 59 of the Stock Corporation Law, despite the existence of other bona fide claims against the corporation. The Court in

365. 155 App. Div. 735, 140 N.Y. Supp. 593 (4th Dept 1913), aff'd, 214 N.Y. 679, 108 N.E. 1090 (1915). See also Whalen v. Strong, 249 App. Div. 792, 292 N.Y. Supp. 385 (4th Dep't 1930), aff'd, 275 N.Y. 516, 11 N.E.2d 321 (1937).

366. 293 N.Y. 404, 57 N.E.2d 733 (1944).

367. Supra note 361.

368. 123 F. Supp. 44 (S.D.N.Y. 1954), aff'd, 228 F.2d 563 (2d Cir. 1955).

369. Id. at 52.

370. See Shaw v. Ansaldi Co., Inc., 178 App. Div. 589, 165 N.Y. Supp. 872 (1st Dep't 1917); Johnson v. Nevins, 87 Misc. 430, 150 N.Y. Supp. 828 (Sup. Ct. 1914).

the *Frye* case placed a remarkably high premium on the litigation-alertness of plaintiff-creditor, stating that "the right of action, of course, is not exclusive, but the fact that the recovery may benefit the alert creditor exclusively is the result, not of the exercise of the right of action but the consequence of the inaction of other creditors similarly situated. A possible recovery by a plaintiff of the full benefit of the statute to the exclusion of each of the other creditors similarly situated, should not operate to defeat his right of action."[372] So cavalier a sacrifice of outstanding creditors' claims on the altar of a single creditor's swiftness to litigate strikes one as an altogether cynical and callous approach to creditors' rights. The legislature, in enacting Sections 719 and 720 of the Business Corporation Law, has rejected this approach by a policy declaration that any recovery in a suit brought against erring directors, on whatever ground and by whomever brought, belongs to the corporation for the benefit of all creditors and shareholders injured as a result of the directors' misconduct. This, indeed, is as it should be—for, any misapplication of funds by directors, whether by negligence, conversion, waste, improper conveyance of corporate assets, or other misconduct, is in the last analysis a misuse of *corporate* funds, title to which is in the corporation and which, in equity, should belong to all creditors and shareholders who can stake out legitimate claims thereto. It might be well to note at this point that, under *paragraph (b) of Section 720*, an action may be brought for the relief provided in paragraph (a) of Section 719 by, among others, a *judgment* creditor on behalf of the corporation. In such case, any recovery by the creditor becomes a corporate fund in which he will share ratably with other creditors (and perhaps shareholders).

Paragraph (d) of Section 719 incorporates the most extensive system in the country for the subrogation of directors who have been surcharged under paragraph (a) of Section 719. *Subparagraph (d) (1)* codifies the common law rule that the director who has suffered a judgment may recover an improper dividend or distribution of assets from the shareholders who received corporate funds knowing the dividend or distribution violated Section 510 of the Business Corporation Law. Since the corporation could have "set aside an illegal conveyance . . . of corporate assets, where the transferee knew of its illegality" under *subparagraph (a) (2)* of Section 720, the director, having made the corporation whole, is subrogated to the corporation's right of action against the transferee-shareholders. This is altogether proper because the injury to shareholders in the misapplication of corporate assets by the director is fully repaired by the director's payment of the judgment against him. Similar subrogation rights are afforded, under the remaining provisions of paragraph (d), to directors, surcharged under the correlative liability provisions of paragraph (a) of Section 719, against; sellers of shares to the corporation who know that

371. 8 N.Y.2d 232, 203 N.Y.S.2d 850 (1960).
372. Id. at 237, 203 N.Y.S.2d at 853.

such sale violated Section 513 (*subparagraph (d) (2)*); shareholders who received an improper distribution of assets during corporate liquidation (*subparagraph (d) (3)*); and directors who received an improper loan in violation of Section 714 (*subparagraph (d) (4)*). In all of the foregoing cases, having made the corporation whole, the director's equity is deemed superior to that of the recipient of the unlawful distribution of corporate assets.

Liability generally: In addition to spelling out the liability of directors for misconduct in specific cases, the new law perpetuates, with minor changes, the form and substance of Section 60 of the General Corporation Law. *Paragraph (a) of Section 720* exposes the directors and officers to a suit by the corporation for the following relief: to compel the defendant to account for neglect of, or failure to perform his duties (*subparagraph (a) (1) (A)*), or for conversion, loss or waste of corporate assets (*subparagraph (a) (1) (B)*); to set aside an illegal distribution of corporate assets where the transferee knew it was illegal (*subparagraph (a) (2)*); and to enjoin proposed illegal distribution of corporate assets (*subparagraph (a) (3)*).[373]

Paragraph (b) of Section 720, the counterpart of Section 61 of the General Corporation Law, provides that an action for the relief provided in paragraph (a) and Section 719 may be brought by the corporation, or by a receiver, trustee in bankruptcy, officer, director or judgment creditor thereof, or, in a derivative suit under Section 626, by a shareholder, voting trust certificate holder, or the owner of a beneficial interest in shares.

The very delineation in paragraph (b), in defining who has the capacity to sue for the relief provided in the section, between suits brought by, or *for*, the corporation and suits brought *in the right of* the corporation suggests the distinction that has been carefully drawn by the courts between the (corporate) statutory action and the derivative action.[374] The assumption is inherent in the creation of the "statutory" action that the decision in a given case as to whether or not relief will be sought is to rest with the entire board. Where the board cannot act because a quorum of disinterested directors is unavailable or, for some other reason, does not *choose* to act, then a *single* director (or officer, or judgment creditor) is authorized to act *for* the corporation. Indeed, the Court of Appeals suggested in *Tenney v. Rosenthal*[375] that a single director

373. Omitted from Section 720 are the provisions in N.Y. Gen. Corp. Law § 60(3) and (4), dealing with the suspension and removal of directors and officers for misconduct by action of the Attorney General. Provision for the amotion of a director is found in N.Y. Bus. Corp. Law § 706(d), and for the amotion of an officer in § 716(c). An officer who is elected by the shareholders (see N.Y. Bus. Corp. Law § 715(b)) can be suspended by the board but cannot be removed except with the consent of the shareholders (see N.Y. Bus. Corp. Law § 716(a)).

374. See West View Hills, Inc. v. Lizau Realty Corp., supra note 241 at 350, 160 N.E.2d at 626 where the dissenting opinion clearly distinguishes the statutory action from the derivative action; Tenney v. Rosenthal, supra note 31 where the very decision turns upon this distinction. See also Peets v. Manhasset Civil Engineer's Inc., 4 Misc. 2d 683, 68 N.Y.S.2d 338 (Sup. Ct. 1946). See generally, for a comprehensive discussion of the area, Note, Director's Statutory Action in New York, 36 N.Y.U.L. Rev. 199 (1961).

375. Id. at 211, 160 N.E.2d at 467.

would have no capacity to sue for the corporation in absence of the statutory authorization. The presumptive authority of the president, qua corporate officer, to bring the statutory action for the corporation has already been sufficiently discussed under the heading "Delegation of the board's authority; executive and other committees."[376] *The extremely important consideration is that a suit by a single director (or officer) for the corporation is not derivative (in the technical sense)*. Hence, in bringing such suit, the director (or officer) is not burdened with such matters as the necessity for a demand upon the board (or the shareholders as a body),[377] "contemporaneous ownership" rule,[378] "security for expenses,"[379] or the like[380]—although he must, of course, allege that he was a director at the time the action was commenced.[381] This vital distinction between the director's (or officer's) statutory action and the derivative suit is highlighted by the judicial recognition that the pendency of a director's action will not bar the commencement of a shareholder's derivative action brought in vindication of the same wrongs by the derelict directors or officers.[382]

CONCLUSION

The subject matter of this paper is patently too extensive for the useful kind of summing-up that is customary upon the completion of a law review commentary. In designing its new law, New York drew freely on the most elucidative sources of corporate statutory material—in the Model Act (which was originally utilized as the structural base for drafting the new law) and the corporate laws of other states. Conformably with the local idiosyncrasies of New York's corporate statutory heritage (which, in some cases, had become so thoroughly inured in the technical arsenal of local practitioners that the statutory legacy could not be renounced), the draftsmen of the new law (with the indispensable assistance of the organized bar) have sought to fashion a modern and forward-looking product. It is a fair observation, which, one trusts,

376. See discussion at notes 240-243, supra.

377. Katz v. Braz, 188 Misc. 581, 66 N.Y.S.2d 722 (Sup. Ct. 1946), aff'd, 271 App. Div. 970, 69 N.Y.S.2d 324 (1st Dep't 1947).

378. See N.Y. Bus. Corp. Law § 626, entitled "Shareholders' derivative action. . . ." (similarly, N.Y. Gen. Corp. Law § 61).

379. See N.Y. Bus. Corp. Law § 627, entitled "Security for expenses in shareholders' derivative action. . . ." (similarly, N.Y. Gen. Corp. Law § 61-b).

380. Directors who acquiesce in the wrong to the corporation by defendant-directors are not estopped from bringing the statutory action for the corporation (see Williams v. Robinson, 9 Misc. 2d 774, 169 N.Y.S.2d 811 (Sup. Ct. 1957)). The rule is otherwise in a shareholder's derivative suit (see cases cited for this proposition at note 29 supra; but cf., Goldberg v. Berry, 231 App. Div. 165, 247 N.Y. Supp. 69 (1st Dep't 1930) which held that no estoppel existed even in shareholder derivative suits where less than all of the shareholders had acquiesced in the wrong. See also, on this point, Williams v. Robinson, supra).

381. Tenney v. Rosenthal, supra note 31. Of course, as the Tenney case holds, the director need not remain one in order to maintain the suit (see discussion of this point at note 31, supra).

382. Lowenstein v. Diamond Soda Water Mfg. Co., 94 App. Div. 383, 88 N.Y. Supp. 313 (1st Dep't 1904).

is supported by the perhaps over-lengthy review in this paper, that New York has rather succeeded in this objective, and has realized a system of corporate statutes which balances sensitively the need for maximum freedom of management in corporate operation, maximum security of the shareholders' investment in the enterprise, and the protection of creditors' rights and public interest generally.